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September 30, 2011

Mr. David Bean
Director of Research and Technical Activities
Project No. 34-E
Governmental Accounting Standards Board
401 Merritt 7, PO BOX 5116
Norwalk, CT 06856-5116

Dear Mr. Bean:

Prior to responding to the Exposure Drafts, I would like to thank the Government Accounting Standards Board and staff for their consideration of the accounting and reporting standards for state and local pensions. This is a very complex and sometimes divisive issue. Your staff has been open to discussions in these matters and their commitment of time and expertise has been greatly appreciated.

I should note that the South Dakota Retirement System is participating in the field testing. Some of my testimony will relate to the testing results to date, but we expect that we will be continuing with the review and evaluation of the Exposure Draft for some months.

I would also request the opportunity to testify at the October 20th public hearing in Chicago.

General Comments

Before discussing some of the testing results, I would like to make some general comments about the exposure draft and certain specific provisions.

First and foremost, we continue to favor the current GASB 25 and 27 standards. While some limited changes may be appropriate for the current methodology, the existing standards have worked very well for many plans, participants, and employers, as well as users of financial statements.

We are concerned that the standards presented in the GASB's Exposure Drafts will prove to be very difficult to administer and the resulting information will confuse policy makers, stakeholders, and financial statement readers in this already complex subject matter. Defined benefit plans are a very important element of compensation in the public sector and are under attack from many sources—frequently based on perceptions and not facts. Standards that create confusion about the long-term nature of the employer pension obligations will not be beneficial to a factual assessment of these plans.

The provisions of the ED will:

• Disconnect pension accounting measures from the funding measures used to determine pension contributions

Disconnecting the pension accounting measures from the funding measure will cause great confusion about what is the appropriate funding for public plans as well as the "true" cost of the obligation, particularly when comparing accounting standards using fair value of assets to funding standards using smoothed actuarial values. Caution should be used in how these measures are defined and described so new required information about accounting is not interpreted to represent funding standards.

• Require employers to recognize an unfunded pension obligation as a balance sheet liability in their basic financial statements based on the fair value of assets

Requiring employers to recognize an unfunded pension obligation as a balance sheet liability based on market value of assets will add a high level of volatility to the financial statement of governments in an environment where the nature of the obligation is proving not to be fixed, but is quite variable. During the last few years many plans have made significant changes to their pension benefits or contribution rates to improve the sustainability of their plans. GASB Concepts Statement 4, paragraph 17, defines the financial statement element liabilities as "present obligations to sacrifice resources that the government has little or no discretion to avoid." This is a key principle guiding the GASB's decision to define the pension obligation as a liability and consequently place the net pension liability on the employer's balance sheet. Governmental employers have been shifting the responsibility to pay the pension obligation to employees by raising their contributions and in some cases lowering certain benefits. South Dakota is among those plans that have taken actions to limit the risk and obligations of employers and will continue to do so in the future if necessary to sustain our plan.

It is our recommendation that the GASB consider a simplified method of recognizing the pension impact on the balance sheet in a single entry which combines the net pension liability, deferred inflows and deferred outflows. We suggest disclosure in the notes to the financial statements showing the detail of a reconciliation of the annual pension activity.

If the provisions of the exposure draft become the final standard, we concur with the blended discount rate process defined in the ED.

• Require employers to recognize a new measure of pension expense in their basic financial statements that may have no relation to the actuarially determined contribution

The ED provides for the recognition of "pension expense" on the basic financial statements. While the term "pension expense" implies a measurement of the annual pension cost, this measure is not related to the "actuarially required contributions" defined in the current standard and certainly creates considerable confusion regarding the appropriate funding level. The term "pension expense" primarily relates to the changes in net pension liability and inflows and outflows that are recognized each year on the financial statements. It would be our suggestion that GASB move away from terminology that has a high likelihood of being misrepresented as a funding requirement.

• Replace most of the current note disclosures and required supplemental information (RSI)

While expanded disclosure can add a level of understanding for certain plan features, it is critical to avoid expanding that presentation to a level that confuses the information or in some cases duplicates the data. As an example, the disclosure of both the time-weighted and money-weighted rates of return is certainly important, but disclosing both in the RSI may not add value for the reader and could very well cause uncertainty and conflict about the results. We recommend that the time-weighted return be disclosed and that the money-weighted rate of return be left for inclusion in the actuarial information.

Field Testing Preliminary Observations

Administrative Costs

As field testing of the exposure draft on pension accounting has proceeded, it has become obvious that the additional responsibilities and expenses for the retirement plans will be immense under the proposed design. The staff of the retirement systems, auditors and actuaries will require dramatically more time to meet the requirements of these proposed standards. We are still working through the details and as indicated above, we will not fully complete our evaluation for some months.

However, our very preliminary estimate of additional time and expenses related to the preparations of the plan's annual financial statements and supportive data to employers for our internal staff, auditors and actuaries is at least 25% greater than the current process. If the plan is required to recalculate the net pension liability, pension expense, and deferred inflows and outflows for all separate employer year ends, the internal costs and the costs for audit and actuarial services may be multiples of the above figures.

Cost-Sharing Employer Allocations

SDRS is a cost-sharing multiple-employer public pension plan and as part of the field testing we surveyed our employers about their fiscal reporting years. The preliminary results indicate that there are six different year ends among the 470 public employers that participate in SDRS. Cost-sharing employer allocations per employer year ends would prove to be very costly and labor intensive to administer, especially when applied to the employers that have a very small number of employees.

Recognizing the costs outlined above, the number of employer fiscal year ends and the limited number of members in the respective year end dates, we recommend that the GASB consider changing the allocation process for cost-sharing plans to the plan's fiscal year end that is within the employer's fiscal year. Recognizing the long-term nature of these obligations, the day-to-day volatility of the asset values and the length of time necessary to compile financial statements, a single allocation process based on the plan's year end would make both administrative and fiscal sense.

The Exposure Drafts define the allocation process based on each employer's "expected long-term relative contribution effort" compared with the collective contribution effort of all employers in the cost sharing plan. We recommend simplifying this process by using the expected current contribution effort of participating employers compared to the total expected current contribution effort. This methodology would be more understandable and less costly to produce. In addition, depending on the funding policy, any estimate of "projected contribution effort" may require expensive contribution forecasting.

Average Remaining Service Life

As currently presented in the Exposure Drafts, changes in the net pension liability due to demographic gains and losses or assumption changes related to active employees are to be recognized over the average remaining service life weighted by the associated change in the active employee's liabilities. The use of the weighting process is outside the normal actuarial methodology, will add additional costs and may dramatically reduce the remaining service life. Although the ED allows for an approximate measure of the effect of weighting, our actuaries have indicated they know of no other method than to perform the calculations individually. Our current estimate for South Dakota Retirement System average remaining service life for active members is approximately 10 years. Preliminary calculations of the SDRS weighted average remaining service life is approximately 5 years. This determination is time consuming and will likely be determined by actuaries in a non-uniform manner. It doesn't add value or increase

comparability. We recommend the final statement clarify that average remaining service life should be measured as a simple average.

Also, current application of the average remaining service life for delaying recognition of changes in net pension liability is limited to assumption changes and demographic gains and losses attributable to active members only. We believe plan changes applicable to active employees should also be recognized over the average remaining service life. Any plan changes, including changes to reduce the pension liability that recently affected SDRS, are part of the employee/employer exchange and should be recognized over the same period as the other changes that impact the net pension liability for active employees.

Rates of Return

We are concerned that the inclusion of both the time-weighted and money-weighted rates of return will cause confusion. For purposes of financial reporting, we believe that the time-weighted rate of return is appropriate. Since the CFA Institute Global Investment Performance Standards for investment performance measurement provide for time-weighted rate of return and time-weighted rate of return net of fees, it seems appropriate that this measure would be disclosed in the notes to the financial statements. The money-weighted rate of return would be used in the actuarial information.

Though we have already brought it to the attention of GASB staff, the illustration of the calculation of the time-weighted rate of returns on page 49 of the amendment of GASB 25 document is incorrect. The formula basis for Period Return should be Investment Income divided by Beginning Value.

Continued Field Testing

As indicated above, SDRS plans to continue the field testing process in order to identify additional issues and build potential reporting structures. As part of this process we are already planning to incorporate other local employers and employer groups into the discussion and analysis. Unfortunately, the local employers, employer groups and other stakeholders have not recognized the importance of this project yet and are not currently engaged.

Conclusions

The South Dakota Retirement System has spent a lot of time and effort to establish policies and procedures that made the implementation of the GASB 25 and 27 standards work well in South Dakota. We continue to feel that the linking of accounting and funding has merit for public pension plans and their stakeholders. In addition, we are very concerned about the potential volatility which will be injected into the financial statements of public employers based on the provisions of the current exposure draft. Public plans have in the last few years already dramatically impacted their financial condition by adjusting contributions, benefits and other plan provisions to improve sustainability.

If the linking between accounting and funding is not maintained, we hope that you will consider the recommendations outlined above. It is critical that the administrative costs and effort be considered in the allocation process for cost-sharing employers. A change of focus to the plan's year end is vital for cost-sharing plans operations.

In addition, great care should be taken with terminology and reporting in order to avoid confusing and conflicting language that blurs the difference between accounting and funding. In particular, the use of the term "pension expense" may prove very problematic. Employers and other decision makers will not easily understand or appreciate the differences in accounting and funding requirements.

Thank you again for the opportunity to provide input. We appreciate the efforts of GASB on this important topic.

Sincerely,

Robert A. Wylie

Executive Director/Administrator South Dakota Retirement System



Response to the Governmental Accounting Standards Board Exposure Drafts on **Pension Accounting and Financial** Reporting by Employers

October 20, 2011





Response to the Governmental Accounting Standards Board (GASB)

South Dakota Retirement System (SDRS) response presented by:

Robert A. Wylie Executive Director/Administrator South Dakota Retirement System

SDRS Overview

SDRS is a consolidated cost-sharing multiple employer public employee retirement system. Nearly all full-time South Dakota public employees and their employers participate in the plan and share the cost of providing retirement, disability and survivor benefits.

Total Members – 74,000 (Total state population - 800,000) Total Benefit Recipients – 20,000 (Total Annuitant Payroll - \$350M) Fiscal Year 2011 Market Value Funded Ratio – 102.9%



GASB 25 and 27

Preliminary Comments:

- The current reporting model is a very good fit with the budgetary process employed in the public sector and thus facilitates an environment of stable contributions.
- In their current form, GASB 25 and 27 appropriately inform users of the financia public pension plans and meet the GASB goals related to accountability and deusefulness.
- The current design also provides a framework which links the accounting and actuarial processes and focuses on the three key questions related to pension benefit funding: - 1) how much must the plan sponsor and member contribute to fund the benefits over
 - 2) have the sponsor and member made the required contribution, and
 - 3) is the sponsor currently ahead or behind in funding?

We do not favor the recognition of the unfunded pension obligation on the employer balance sheet and are concerned that the proposed standards will substantially increase administrative costs and more importantly, create confusion for policy makers, stakeholders and the public.

The remainder of my comments relate to the proposed model and the field testing



Response To the GASB Exposure Draft

General Comments and Concerns about the Exposure Draft:

- Disconnecting pension accounting and funding will cause great confusion about what is the appropriate funding measure for public plans.
- Caution should be used in how pension accounting elements are defined and described so they are not misinterpreted to represent funding standards. For example, "pension expense" implies a funding cost and conflicts with GASB's intent to de-link accounting from funding.
- The nature of the employers obligation is proving not to be fixed. A large number of plans have shifted more of the responsibility to pay the pension obligation to employees. Some states have statutory or case law that allows them to reduce benefits. South Dakota is among those plans.
- If the proposed reporting model moves forward, consideration should be given to simplifying the financial statement annual recognition for pensions to a single line item with calculation disclosures in the footnotes.



Response To the GASB Response To the SDRS Exposure Draft

Field Testing Preliminary Observations:

Administrative Costs

- Initial SDRS estimates for administrative costs associated with the preparation of the plan's annual financial statements and supportive data for our internal staff, auditors and actuaries is at least 25% greater than the current process. If the plans are required to make additional actuarial and accounting calculations for all separate employer year end dates, the internal costs and the costs of audit and actuarial services will be multiples of the above figures.
- We will not fully complete our field testing for months.

- Preliminary results of employer surveys indicate that there are six different year ends among the 470 public employers in SDRS. To allocate net pension liability, pension expense, and deferred inflows and outflows for all separate year ends would be prohibitively costly and not within our current resources and budget authority. We highly recommend that the GASB consider using the plan year end that falls within the employer's fiscal year for allocation.
- We also recommend that the employer's current expected contribution effort be used for allocation instead of the expected long-term relative contributions effort.



Response To the Exposure Draft **Response To the GASB**

Field Testing Preliminary Observations Con't:

Average Remaining Service Life

- Changes in the net pension liability due to demographic gains and losses or assumption changes related to active employees are to be recognized over the average remaining service life weighted by the associated change in the active employee's liabilities. The use of the weighting process will dramatically reduce the remaining service life. Our initial testing indicates the SDRS average remaining service life for active members is approximately 10 years. Preliminary calculations of the SDRS weighted remaining service life is 5 years. We recommend that remaining service life is 5 years.
- Delayed recognition of changes in net pension liability is limited to assumption changes and demographic gains and losses attributable to active employees only. We recommend that plan changes applicable to active employees be recognized over the average remaining service life and thereby recognize all active employees changes over the same period.

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Field Testing Preliminary Observations Con't:

Rates of Return

- Inclusion of both the time-weighted and money-weighted rates of return will cause confusion and possibly conflict. We recommend that only the time-weighted rate of return based on the CFA Institute Standards be disclosed.
- We have already reported it to your staff, but the illustration of the calculation of the time-weighted rate of return on page 49 of the amendment to GASB 25 document is in error.

Continued Field Testing

SDRS plans to continue the field testing process in order to identify additional issues and build potential reporting structures. We are very concerned that local employers, employer groups and other stakeholders have not recognized the importance of this project yet and are not currently engaged.



Concluding Remarks

- The current pension accounting and financial reporting established by the Governmental Accounting Standards Board has served the South Dakota Retirement System and its stakeholders very well.
- The current design has allowed SDRS to maintain interperiod equity in contribution rates, to provide useful and easily understood information for decision makers and accountability that matches the funding practices based on long-term sound actuarial recommendations.
- The public pension industry is at a crossroads. Several states are currently involved in legal actions related to members' contractual rights to benefits and several other systems have or are planning to make benefit or contribution changes based on the financial condition of their plan. The results of these legal challenges will have a direct impact on an employer's obligation for pension benefits.
- We favor the current standards and continued linking of accounting and funding and are concerned about the volatility inherent in the ED.



Concluding Remarks

In summary, our specific recommendations outlined with regard to the Exposure

- Simplify the reporting and accounting and eliminate excessive costs by allocating pension obligations to cost-sharing employers based on the Plan's year end
- Avoid terminology that confuses accounting requirements with funding standards (Pension
- Simplify the pension recognition to a single line in each of the employer's financial statements
- Simplify the calculation of average remaining service life and recognize plan changes for active employees over remaining service life (Remove the weighted
- Adopt the CFA Institute Standards and disclose time-weighted rates of return