# OHIO PUBLIC EMPLOYEES RETIREMENT SYSTEM

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More Than 75 Years Strong

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Director of Research and Technical Activities Governmental Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Subject: Project 13-3 (Preliminary Views on Economic Condition Reporting: Financial

Projections)

#### Dear Board and Staff:

The Ohio Public Employees Retirement System (OPERS or System) is pleased to have the opportunity to provide comments to the Governmental Accounting Standards Board (GASB) on the Preliminary Views document, "Economic Condition Reporting: Financial Projections".

### Overview of OPERS

OPERS is a multiple employer cost sharing retirement system that includes members in all facets of public employment. The following background information provides context for our comments regarding the Preliminary Views (PV) document, and the role we anticipate the System will be expected to perform in the implementation of the proposed standard.

All public employees in Ohio, except those covered by one of the other state or local retirement systems in Ohio, are members of OPERS. Employees of 3,700 employers are categorized into one of four divisions based on the functions performed: state or local government, public safety, and law enforcement, each with different contribution rates and benefit formulas as established in state statutes. OPERS provides benefits to its members through three pension plans and two health care plans. The pension plans include a pure defined benefit plan, a pure defined contribution plan, and a hybrid plan with components of both a defined benefit and a defined contribution plan. A post-employment health care plan is available for qualified members in the defined benefit and hybrid plans, and a Voluntary Employees Beneficiary Arrangement is available for members in the defined contribution plan.

We anticipate that the PV requirements would likely place OPERS in the position of projecting the pension and OPEB liabilities for our employers for each of the next five years. The GASB Exposure Draft on pension reporting highlighted a number of difficulties that multiple employer cost sharing systems will encounter in attempting to assign a portion of pension expense and pension liability to employers for a single year. The five year projection requirement proposed in the PV will significantly magnify these difficulties and the corresponding cost of implementation for retirement systems.

## **Concerns with the Preliminary Views Document:**

OPERS does not support the GASB's position expressed in the PV document requiring five year financial projections as Required Supplementary Information in the System's Comprehensive Annual Financial Report (CAFR), particularly as it relates to fiduciary funds such as pensions and other post-employment benefits plans (OPEB).

Inclusion as Required Supplementary Information in CAFR

The GASB believes that these projections will provide decision makers with information needed to assess a government's economic condition and its fiscal sustainability in honoring current service commitments. While we do not disagree with the fundamental precept regarding the merits of financial projections, we do not believe that the CAFR and the Required Supplementary Information (RSI) section are the appropriate documents to report these projections.

GASB Concept Statement 3 defines RSI and the criteria for presenting information in this section. RSI is defined as supporting information that is essential for placing the basic financial statements and notes in an appropriate context. The RSI is to have a clear and demonstrable relationship to information in the basic financial statements or notes to the basic financial statements to which the RSI pertains. By their nature, the basic financial statements are historical information based upon past, known events. Inclusion of projections as indicated by the PV would require the preparation of cash flow statements for future periods, but none for the immediate past. These projections are akin to forecasts as they are not based on future transactions to which a government entity is bound by a current contract or law.

We believe that much of the information relevant to fiscal sustainability is already available within the financial statements, their footnotes, and other schedules / sections currently contained within the CAFR.

#### Usefulness of Projections

We do not believe that retirement systems should be subject to the requirements of the PV, as the five year projections are not meaningful in determining fiscal sustainability. Pension and OPEB plans are designed, structured, and funded based upon a long term perspective, reflecting a time horizon encompassing a member's working career and retirement – a span of 50 to 75 years. Sustainability is determined by monitoring the long term actuarial measures of funded status, the payment of annual required contributions, and solvency. These measures and trends are already included in the CAFR's notes to the financial statements, required supplementary information, actuarial and statistical sections. The inclusion of short term financial projections could be misinterpreted when compared to the long term measures, and could potentially lead to inappropriate action.

State Statutes and Coordination with GASB Exposure Drafts on Pension Reporting

The PV requires governmental entities to provide projections of their total financial obligations including pensions and other post-employment benefits. It is not clear how the requirements of the PV would correlate with the requirements of the GASB ED on pension reporting.

OPERS has provided the GASB with comments and concerns regarding implementation issues related to the GASB ED with respect to cost sharing multiple employer systems. These concerns included the validity of the allocation process of the aggregate pension expense and net pension liability at the employer level, and the difficulty in projecting long

term contributions for all employers in an environment of changing staffing levels. The GASB has not yet released a preliminary views document on OPEB reporting that would provide cost sharing multiple employer systems with guidance on how to calculate and allocate an OPEB expense or liability. However, we expect that our employers will look to OPERS to prepare their five year projections of pension and OPEB obligations.

As noted in our comments to the GASB ED, Ohio statutes hold employers liable for only the contribution rates established by the legislature in statute. Since the member and employer contribution rates cannot increase or decrease in response to funding changes, the pension benefits and health care plan are modified periodically to adjust for changes in the unfunded liability. The amount of funding to the health care plan is modified on an annual basis and has historically ranged from 7% to 0%, with both increases and decreases occurring and at times multiple times within the same year. The design of the health care (OPEB) plan is completely within the control of the OPERS Board of Trustees, and can be and has been modified as necessary by the Board based on the funding status of the plan. In the unlikely event of a pension plan termination or default, the state legislature would determine the final dispensation of any unfunded liability. The assignment of these liabilities to employers can be misleading given the structure within Ohio, and raises a question regarding the application of accounting standards that are not in accordance with state statutes.

The PV states that assumptions employed in making projections would be consistent with each other and comprehensive by considering significant trends, events, and conditions. Assuming the GASB ED is finalized in its present form, OPERS would be required to allocate the net pension liability to employers based on the projected long term contributions of the employer as a ratio of the total projected long term contributions of all employers. This allocation is basically a "pro-rata" share distribution based on projections of the aggregate workforce of all employers as determined by the OPERS actuary.

The PV requirements would likely place OPERS in the position of projecting this liability for employers for each of the next five years. However, the forecasts prepared by OPERS 3,700 individual employers may include assumptions about downsizing or privatization of governmental functions of which OPERS is not aware. The assumptions used by the employer for their cash inflow and outflow projections would not be consistent with the projections of pension and OPEB financial obligations calculated by OPERS.

### Timing and Resource Demands

As noted in our response to the GASB ED, the variability (and volatility) of data based on multiple employer year ends will require roll-forward procedures of projected pension (and OPEB) obligations based on the fiscal year ends of our 3,700 employers. Many of our employers complete their year-end close process within 3 months of their fiscal year end. Delays inherent in the valuation of pension and OPEB liabilities at the employer level and at the employer's fiscal year end will not permit OPERS to provide employers with the required disclosures in time to meet their annual / fiscal year-end financial reporting deadlines.

Supporting our employers in the implementation of the proposed standard will also be a costly undertaking by OPERS through additional actuarial services and internal staff resources necessary to prepare the required five year projections. State statutes do not permit OPERS to bill employers for amounts other than the contribution rates established in statute. Case law related to the pension systems has also ruled that the Ohio retirement systems have no authority beyond what is conferred to them under their governing statutes. Accordingly, OPERS would be responsible for paying these additional costs, which could be construed as a violation of Internal Revenue Code's "exclusive benefit rule" (IRC 401(a)(2)).

### Responses to Specific Questions asked by the GASB

- 1. The Board's preliminary view is that there are five components of information that are necessary to assist users in assessing a governmental entity's fiscal sustainability (Chapter 3, paragraph 2):
  - Component 1 Projections of the total cash inflows and major cash inflows, in dollars and as a percentage of total cash inflows, with explanations of the known causes of fluctuations in cash inflows (Chapter 3, paragraphs 4-9)
  - Component 2 Projections of the total cash outflows and major individual cash outflows, in dollars and as a percentage of total cash outflows, with explanations of the known causes of fluctuations in cash outflows (Chapter 3, paragraphs 10-14)
  - Component 3 Projections of the total financial obligations and major individual financial obligations, including bonds, pensions, other postemployment benefits, and long-term contracts, with explanations of the known causes of fluctuations in financial obligations (Chapter 3, paragraphs 15-20)
  - Component 4 Projections of annual debt service payments (principal and interest) (Chapter 3, paragraphs 21-23)
  - Component 5 Narrative discussion of the major intergovernmental service interdependencies that exist and the nature and scope of those service interdependencies (Chapter 3, paragraphs 24-26).

## Do you agree with this view? Why or why not?

We do not agree that these are the appropriate components for a long term pension or OPEB plan. We believe the long term fiscal sustainability issue is best evaluated using the actuarial measures already encompassed in the footnotes to the basic financial statements, the RSI, and the actuarial and statistical sections of the retirement system's CAFR.

Components 1 and 2 are not appropriate for a large institutional investor and add little value to the sustainability perspective. Although retirement systems have some ability to project cash inflows and outflows related to contributions and benefits, investments by far comprise the majority of the cash flow activity. Investment cash flows represent purchases and sales of investment instruments through normal trading activity, rebalancing and reallocation of assets in accordance with investment policies and market conditions. These transactions are recorded on an accrual basis that recognizes the differences between trade and settlement dates. Attempting to convert these transactions to a cash basis can result in significant distortions related to investment receivables and payables, and unrealized / realized gains and losses.

Component 3 – As previously noted, we have great concerns with the projection of pension and OPEB liabilities on a short term five year projection window. The largest contributor to a change in the unfunded liability is investment gains or losses that are currently smoothed over a four year period. The GASB ED on pension reporting will require the use of the market value of assets, increasing the volatility of short term projections. We also question the conclusions that can be drawn from the disparate treatment of inflows and outflows on a cash basis with financial obligations reported on an accrual basis.

Components 4 and 5 are not relevant to OPERS as a public pension system. To the best of our knowledge, in its 75 year history OPERS has never obtained a debt instrument. As currently proposed, component 5 is limited to service interdependencies rather than fiscal interdependencies as fiscal interdependencies would be presented as part of components 1 and 2. Accordingly, as a retirement system we do not have intergovernmental service interdependencies as we understand this term to apply in the PV.

2. The Board's preliminary view is that financial projections should be (a) based on current policy, (b) informed by historical information, and (c) adjusted for known events and conditions that affect the projection periods. Current policy includes policy changes that have been formally adopted by the end of the reporting period but that will not be effective until future periods (Chapter 4, paragraphs 2-7). Do you agree with this view? Why or why not?

Recognizing our fundamental disagreement with the GASB's view of providing this information as RSI, we also have concerns with this specific proposal. The GASB's proposal requires financial projections to be based on current policy, including changes that have been formally adopted by the end of the reporting period but that will not be effective until future periods. Most governmental entities complete their CAFRs within six months of the end of their fiscal year. Changes adopted within this six month period that could have a significant impact on the projections would not be considered. In effect, the projections would be outdated before the CAFR is issued. However, attempting to incorporate post reporting period changes in the projections would further delay an already prolonged annual report preparation process. This dilemma emphasizes the somewhat subjective nature of the projections and the potential for users of the financial data to draw inappropriate conclusions.

3. The Board's preliminary view is that inflows and outflows should be projected on a cash basis of accounting, and financial obligations should be projected on an accrual basis of accounting (Chapter 4, paragraphs 8-12). Do you agree with this view? Why or why not?

We disagree with the approach of mixing cash and accrual basis projections as suggested by GASB. As previously noted under question 1, investment trade transactions comprise the most significant inflow / outflow activity of a retirement system. Projecting this activity on anything but a full accrual basis of accounting could result in significant distortions of available resources.

4. The Board's preliminary view is that the identification and development of assumptions for making financial projections should be guided by a principles-based approach. Such an approach would set forth principles that require assumptions to be based on relevant historical information, as well as events and conditions that have occurred and affect the projection periods. Furthermore, these assumptions should be (a) consistent with each other (where appropriate) and within the information used as the basis for the assumptions and (b) comprehensive by considering significant trends, events, and conditions (Chapter 4, paragraphs 13-16). Do you agree with this view? Why or why not?

Recognizing our fundamental disagreement with the GASB's view of providing this information as RSI, we also have concerns with this specific proposal as it relates to pension and OPEB obligations and the GASB ED regarding pension reporting. As previously noted, the PV requirements would likely place OPERS in the position of projecting these liabilities for employers for each of the next five years. However, the forecasts prepared by individual employers may include assumptions about staffing levels that include planned downsizing or privatization of governmental functions of which OPERS is not aware. The assumptions used by the employer for their cash inflow and outflow projections would not be consistent with the projections of pension and OPEB financial obligations calculated by OPERS.

5. The Board's preliminary view is that annual financial projections should be made for a minimum of five years beyond the reporting period for the purpose of external reporting (Chapter 4, paragraphs 19-23). Do you agree with this view? Why or why not?

Recognizing our fundamental disagreement with the GASB's view of providing this information as RSI, we also do not agree that five year projections for retirement systems are meaningful measures of sustainability for external reports of long term pension and OPEB plans.

6. The Board's preliminary view is that all of the components of fiscal sustainability information are essential for placing the basic financial statements and notes to the basic financial statements in an operational or economic context and therefore should be required and communicated as required supplementary information (Chapter 5, paragraphs 7-12). Do you agree with this view? Why or why not?

As stated in our opening comments, we do not agree that the five components listed in the PV belong in the RSI. We believe the proposal conflicts with the principles provided in Concept Statement 3, for the reasons previously stated.

We believe there is merit in long term projections in analyzing sustainability and the sensitivity of pension and OPEB obligations, and this long term perspective can be obtained from other documents such as the annual actuarial valuations prepared for retirement systems. We do not believe the CAFR is the appropriate vehicle to communicate these projections, as the CAFR is a historical view of actual events. We are concerned with including short or long term projections in a report of actual activity due to the unreliability of the projection information. Despite the disclaimer that would precede the display of financial projections, there is a risk that the credibility of the financial statements will be undermined if readers attribute variations between actual results and projections in the RSI as a reflection of the accuracy of the financial statements themselves.

7. The Board's preliminary view is that all governmental entities should be required to report financial projections and related narrative discussions (Chapter 5, paragraphs 13 and 14). Do agree with this view? Why or why not?

We do not agree that all governmental entities should be required to report financial projections and related narratives as a component of the CAFR. We believe that reports of financial projections for entities such as retirement systems that derive a significant portion of their cash flows from long term investment activities will be misleading, unreliable, and misunderstood.

We also disagree that a five year or longer term projection period is an appropriate means of analyzing the fiscal sustainability of retirement systems. Fiscal sustainability in large part is determined both by investment returns and plan design features which can be modified to maintain solvency. The projection process does not take changes approved after the end of the reporting period into consideration, making them inappropriate predictors of future obligations.

Note – We see no value in preparing these projections for defined contribution plans as the obligations related to these plans are always equal to the market value of their assets.

8. Do you believe that a phase-in period for implementing the reporting requirements for financial projections and related narrative discussions would be appropriate (for example, requiring governmental entities over certain dollar thresholds to implement first)? If so, what phase-in criteria would you recommend (Chapter 5, paragraph 14)?

Recognizing our fundamental disagreement with the GASB's view of providing this information as RSI, we do agree that if the GASB pursues this reporting requirement a phased implementation is appropriate. However the use of a dollar threshold as the determining factor will result in retirement systems that will have the most difficult implementation process being required to implement first.

### **Summary:**

GASB Concepts Statement 1 states that to be effectively communicated, information in financial reports should possess six qualitative characteristics: relevance, reliability, comparability, consistency, timeliness, and understandability. The GASB PV itself states that "If the reporting of financial projections and related narrative discussions is to be effectively communicated it needs to possess all six qualitative characteristics." We believe that the long term perspective of pension and OPEB plans fails this test in the preparation of financial projections.

As noted in the PV, Concept Statement 1 (paragraph 79) also states that "Financial reporting should assist users in assessing the level of services that can be provided by the governmental entity and its ability to meet its obligations as they become due." In drafting the PV, we believe the GASB has taken an overly broad interpretation of this precept. The preparation of five year financial projections that are based on projections that go beyond current contractual obligations as they become due, and which do not consider an entity's ability to modify services or generate additional revenues, do not assist the user in evaluating fiscal sustainability.

We appreciate the opportunity to comment on the Preliminary Views of the GASB on major issues related to Economic Condition Reporting: Financial Projections. Questions regarding this letter may be directed to Karen Carraher, Executive Director at 614-222-0011, or to Charlene Powell, Assistant Director – Financial Reporting at 614-225-8998.

Sincerely,

Karen Carraher, CPA Executive Director, OPERS