Letter of Comment No. 119
File Reference: 13-3PV
Date Received: 3/16/12

Commonwealth of Pennsylvania
State Employees' Retirement System
30 North Third Street, Suite 150
Harrisburg, Pennsylvania 17101-1716
www.sers.state.gov
Office of Finance and Administration
Telephone: 717-787-7297
FAX: 717-783-1708

March 16, 2012

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

Project No. 13-3

On behalf of the Commonwealth of Pennsylvania State Employees' Retirement System (SERS), thank you for the opportunity to review and comment on the Preliminary Views-Economic Condition Reporting: Financial Projections (PV). As a public pension system and a component unit of the Commonwealth of Pennsylvania, SERS is providing responses to the questions in the Preliminary Views based solely on the business conducted within the agency.

SERS, which was established on June 27, 1923, provides retirement benefits to the employees of the Commonwealth of Pennsylvania and is a cost-sharing, multiple-employer defined benefit pension plan. As of December 31, 2011, SERS had $24.1 billion in assets, 106 participating employers, distributed $2.7 billion in benefits annually to approximately 115,000 retirees and beneficiaries, and covered approximately 107,000 active members.

The overall direction of the PV is to provide the user with information to assess a government's economic condition via its financial position, fiscal capacity and service capacity. We believe these requirements are far beyond the scope of our organization and provide an extremely short-term view to an entity that is perceived to be in existence in perpetuity. While fiscal sustainability is important, financial projections are very subjective; and therefore, should not be part of the audited financial statements, notes to the financial statement, or required supplementary information.

For a government's general fund, where tax revenue is a major source of revenue, projecting tax revenue is much more predictable due to the fact that the government can raise or lower taxes when needed to adjust to the swings of the economy, and therefore tax revenue is relatively stable. As a pension system however, SERS primary source of revenue is derived from investment earnings. Over the past ten years 74% of SERS funding was from investment earnings. Projecting the earnings the markets will gain or lose in any particular year is difficult if not impossible. In order to meet the long-term obligation of providing for pensions, SERS makes long-term assumptions (30 years or more) to ensure sustainability of the plan. There is no one-year or five-year period that would paint a true picture of this long-term period. This clearly can be seen in SERS investment returns. SERS assumes an 8% rate of return on its investments. This rate is not expected to be met in any given year but rather as an average over many years. In fact, history shows that rate varies significantly from the 8% in any given year. For example, in 2008, SERS return was a negative 28.7%. This return varied 45.5 % from the 17.2% positive return just a year earlier. This fluctuation in return represents a $16.3 billion dollar swing in investment income from one year to the next. Even the five-year return varied significantly for those two years. For the five years ending December 31, 2007, SERS'average annualized return was 17.5%. The five-year average annualized return for five years ending December 31, 2008 was only 5.1%. But, despite these significant fluctuations, SERS long-term return was very close to its assumed rate of return, which was 9% for the 20 years ending 2008.

Financial statements are based on facts, projections are based on trends. Due to the volatility of today's economic cycles, political events, and unpredictability of short-term market fluctuations, trends cannot be used to predict future investment returns; therefore, financial projections will be misleading to the user of the financial statements. While the government can disclose the assumptions used in calculating their projections they cannot accurately predict economic or political events that pose a major impact on their financial situation. Projections as part of the overall financial statement could very easily be mistaken by the user to be fact and cause them to make bad financial decisions.

In the Commonwealth of Pennsylvania, projections are more likely to be used in the budgeting process as it is helpful to know future expenditures. Government agencies, including SERS, are required to submit cash flow projections for a seven year period. All of this information can already be accessed readily on the Commonwealth's web site. In addition to these projections, constant updates to the current budget are also posted.

As a public pension system, SERS has an annual Actuarial Valuation. The report based on this valuation contains schedules that project major inflows and outflows to the System for 11 years as well as a narrative description of the factors used to derive these projections. The entire report is posted on SERS website at www.sers.state.pa.us. Since SERS is prohibited from issuing pension obligation bonds, the System does not have debt to outside parties. Therefore, SERS is already providing some of the information suggested in the PV to our users on our website; however, it is done in the context of a long-term analysis of an actuarial valuation, which we believe this is a much more appropriate manner to present projections.

One area in the PV that GASB needs to clarify is the entities that will be required to report projections. The summary of the PV clearly states that this PV is for governmental activities and business-type activities of the primary government and only pertains to the general fund. This view is reinforced on page 26, Inclusion of Component Units, when GASB states "The Board's preliminary view is that governmental entities should not be required to report financial projections and related narrative discussions on their discretely presented component units." The last sentence of this section (page 27) eludes that component units would be reporting their own financial projections. Based on the above statements, SERS is unclear of the audience for this PV and feels GASB has created confusion.

In conclusion, SERS feels implementation of this PV would not be cost beneficial to governmental entities. SERS would be required to pay additional internal costs for employees to prepare the schedules as well as additional external costs to the actuary and auditor to calculate and review the information. The information provided to the users of the financial statements not only wouldn't justify these additional costs, but also may mislead the user due to the unpredictability of SERS major income source and misunderstanding the long-term applicability of actuarial methods and assumptions used to determine projections.

Please see the following responses to each of the individual questions posed in the PV:

Question 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): Do you agree with this view? Why or why not?

We disagree with this statement for the reasons stated in our introductory paragraphs.

Question 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?

We disagree with the criteria listed. As stated in the opening remarks, a large portion of SERS revenue (74% over the past 10 years) is derived from investment earnings. Historical information cannot be used to predict investment results for any given year or five-year period. If SERS would have used the historical results from 2003-2007 to project 2008, users of our financial statements would have been severely misled.

Question 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?

Again, while we disagree with placing projections in the financial statements, we agree with this view. Cash flow should always be reported on a cash basis and the financial obligations should be reported on the accrual basis.

Question 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 with 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?

SERS believes that projections should be guided by a principles-based approach. However, there are factors within every government that make it difficult if not impossible to make reasonably accurate projections. Some of these factors include the ever changing political and economic climate as well as the unpredictability of short-term investment returns that have a major impact on revenue.

Question 5. The Board's preliminary view is that annual financial projections should be made for a minimum of five individual 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?

As described in our introductory paragraphs, even five years can be very misleading to the users of the financial statements.

Question 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?

We disagree with this statement for the reasons stated in our introductory paragraphs.

Letter of Comment No. 119
File Reference: 13-3PV
Date Received: 3/16/12

Question 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 you agree with this view? Why or why not?

We disagree to financial projections being placed in the financial statements. The role of our reporting is fact based driven, and not based on reporting trends. Reporting of projections would only raise more questions by the users, such as: why was a certain interest rate used?; why are projections only limited to a five-year period?; etc. As future projections are prepared, look back comparisons will be made, and it will become more evident that no reliance on those projections can be made. For instance, in 2006, the Unfunded Actuarial Accrued Liability (UAAL) for SERS was $2.2 billion. Since then, unforeseen market conditions, economic conditions, and legislative code changes ultimately caused the UAAL to be $9.7 billion as of 2010, a 340% change in only 4 years, of which no projection would have picked up on. However, if it is decided that projections will be part of RSI, we feel it is imperative that a narrative discussion be included. Because the nature of a projection is very subjective, an explanation of the assumptions used to calculate the projections must be included.

Question 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)?

If required to do it, we do not believe that a phase in period is necessary.

Again, we thank you for the opportunity to review and comment on the PV.

Sincerely,

Anthony J Faiola

Anthony J. Faiola
Chief Financial Officer
State Employees' Retirement System
717-237-0315
E-mail: afaiola@pa.gov