STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF LOCAL GOVERNMENT AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-1402
PHONE (615) 401-7841

December 16, 2014

MEMORANDUM

TO: Certified Public Accounting Firms

FROM: Jerry E. Durham, CPA, CGFM, CFE
Assistant Director
Division of Local Government Audit

SUBJECT: ***A Plan for Auditing Local Government Employer Net Pension Liability under GASB 68 – For Governments Participating in the Tennessee Consolidated Retirement System***

The Governmental Accounting Standards Board (GASB) recently issued three statements related to pensions (i.e. GASB Statements 67, 68, and 71). GASB Statement 68, "*Accounting and Financial Reporting for Pensions*" and GASB Statement 71 "*Pension Transition for Contributions Made Subsequent to the Measurement Date"* are effective for employers with fiscal years ending June 30, 2015. These new standards will affect reporting for all local government employers that have a pension plan. The Tennessee Consolidated Retirement System's (TCRS) actuarial valuation and measurement date for the June 30, 2015, employer's net pension liability calculation has been determined to be June 30, 2014.

Teachers of Local Education Agencies (LEAs) participate in a Cost-Sharing plan. All other government employees, including non-teachers of LEAs, participate in an Agent Plan. TCRS and its Actuary will provide each local government employer with all pension data necessary for auditors to perform their audits and report net pension liability, pension expense, and deferred outflows and inflows for each type of pension plan. The plan outlined below specifically relates to Agent Plans.

The audit plan outlined below is based on the AICPA Whitepaper published by the State and Local Government Expert Panel (SLGEP) *Governmental Employer Participation in Agent Multiple-Employer Plans: Issues Related to Information for Employer Reporting*. This memo assumes that each CPA firm has read and is knowledgeable of the Whitepaper. The Whitepaper can be accessed at:
http://www.aicpa.org/interestareas/governmentalauditquality/resources/gasbmatters/pages/gasbpensionsissues.aspx

Audit Plan - Step 1

Actuarial Reports and Related Documents – TCRS, in cooperation with its Actuary, will provide each participating government with six items of documentation as required by GASB Statements 68 and 71 and/or the related AICPA Whitepaper:

1. Actuarial Certification Letter from the Actuary
2. Actuarial Valuation Report as of the Measurement Date
3. Template Notes to the Financial Statement for each Pension Plan, RSI, and Notes to RSI
4. Amortization Schedules for Deferred Outflows and Inflows
5. Census Data used in the Actuarial Valuations
6. All Journal Entries Necessary for Recording Net Pension Liability, Pension Expense, and Deferred Outflows and Inflows.

This information is tentatively scheduled to be released in March of 2015. The Actuary for TCRS will be considered management's actuarial specialist in accordance with the Whitepaper recommendations. The Division of State Audit (State Audit) will perform audit procedures relative to the work of a specialist and the Division of Local Government Audit (Local Government Audit) will review and approve the audit procedures for use by local governments and their auditors. <u>A report concerning the TCRS actuarial specialist will be provided to each CPA firm via Local Government Audit's website.</u>

Audit Plan - Step 2

Journal Entries and Allocations - Each local government will be responsible for recording the journal entries provided by TCRS and its Actuary (see **Step 1**). The Net Pension Liability, Pension Expense, and Deferred Outflows and Inflows must be allocated between the Governmental Activities and Business-type Activities when appropriate. We recommend that the allocation be based on each fund's respective contributions to the Pension Plan for the fiscal year under audit (i.e. FYE June 30, 2015). However, GASB **does not** specify the method that should be utilized to make these allocations and materiality will be an important factor in determining the level of reporting that is required.

Allocation will also be necessary for Component Units of the Primary Government. This may be difficult. (Guidance can be located in the GASB *Guide to Implementation of GASB Statement 68 on Accounting and Financial Reporting for Pensions* – Questions 33, 34, and 35.) There are some possible ways around the allocation problems. **Where legally possible**, we recommend using one of the following methods to avoid the allocation issue:

A. Legally separate Component Units of the Primary Government that do not have a separate TCRS account should contact TCRS to determine whether or not a separate TCRS account should be established for the Component Unit. (Most legally separate Component Units should already have a separate TCRS Account.) This way, TCRS and its Actuary would provide the information in **Step 1** directly to the Component Unit.

B. The Component Unit may be operated as a **Department** of the Primary Government rather than a Component Unit.

C. Component Units may not have any employees. Employees could work for the Primary Government but be assigned work responsibilities that relate to the Component Unit (e.g. Sheriff's Dispatcher assigned to also be the dispatcher for the E-911 District.) The Dispatcher would be paid through the Primary Government and therefore the pension costs would be assigned to the Primary Government rather than the E-911 District. The Dispatcher would be under the supervision of the County Sheriff. This option may involve legal employment issues that are difficult to overcome. Still, some governments have made this work (e.g. a lease contract for employee services).

Still another option would be to use **materiality** to determine whether or not pension allocations are necessary.

When it is necessary to allocate pension costs to a Component Unit, we propose the following guidance:

Allocate the pension costs to the Component Units based on some rational basis and report Net Pension Liability, Deferred Inflows and Outflows, and Pension Expense on the Financial Statements of the Component Unit. The Notes to the Financial Statements should also include Pension Disclosures. We recommend, one year's pension contributions as an allocation method. The allocation process will take considerable effort and may increase costs to the employer for your services. (See Pension Implementation Guide, Questions 33, 34, and 35).

Audit Plan - Step 3

Testing of Census Data - The Division of State Audit (State Audit), for purposes of local government employers, will utilize Option 2 in the Whitepaper. State Audit will perform an Examination Engagement on Census Data Maintained by the Plan. This Examination Engagement will cover TCRS assertions related to Census Data for **Inactive** and **Retired** TCRS members. The Examination Engagement will be made available to Contract CPA firms via Local Government Audit's website. This means that CPA firms **will not** need to test Census Data for **Inactive** or **Retired** Employees.

CPA firms who audit local government employers **will be** involved in testing census data for **Active** TCRS employees. This will involve a test for accuracy and a test for completeness. The Whitepaper mentions tests that auditors "may" perform, but the following tests are considered mandatory by Local Government Audit. These tests are designed to ensure that the employer's Census Data, upon which the actuarial reports are based, is reliable for obtaining sufficient appropriate audit evidence about each element of Pension Costs. TCRS will provide Actuarial Census Data to each local government employer (see **Step 1**). This data should be utilized to select a sample for testing. CPA firms may also request their client's to access the TCRS Concord System to obtain the Census Data that will be tested for accuracy. This is possible because State Audit will perform audit procedures to determine that the data agrees with Census Data submitted to the Actuary. So effectively, by using the actuarial census data provided or the Concord System, we are testing Actuarial Data to the employer's accounting records. This data will be tested for the period July 1, 2013 to June 30, 2014.

Accuracy Test -

A. Test the accuracy of following data elements for **Active** Employees: Name and Social Security Number (or other ID); Date of Birth, Salary reported for the one-year period; Service Credit reported for the one-year period; Retirement Code, Department Code, and whether the member is Male or Female. We believe these will provide a sufficient amount of audit evidence.

B. A sample of employees should be selected using a random or systematic approach. Employees hired after June 30, 2014, should be excluded from the sample.

C. Government Employers should be asked to locate and provide physical audit evidence to support the data reported for each employee selected for testing.

D. The sample should be selected in accordance with the AICPA's March 2014 edition of the Audit Sampling Guide. In other words, this is a true sample not a test performed using auditor judgment.

E. The purpose, scope, source, and conclusion of the sample should be included in the audit documentation. The reason for all discrepancies should be documented if possible. If the overall test reveals that the Census Data is not accurate, CPA firms should notify Local Government Audit, write a detailed finding, and determine whether or not an Unmodified Opinion can be issued.

Completeness Test –

A. Another sample should be selected directly from the employer's payroll records. Each employee selected should be tested back to the Actuarial Census Data provided (see **Step 1**) or to the TCRS Concord System through access provided by the employer. If any employee does not show up, the CPA firm should determine the reason (e.g. part-time, not eligible for TCRS).

B. The purpose, scope, source, and conclusion of the sample should be included in the audit documentation. If the overall test reveals that the Actuarial Census Data (see **Step 1**) or the TCRS Concord System does not include all eligible employees, CPA Firms should notify Local Government Audit, write a detailed finding, and determine whether or not an Unmodified Opinion can be issued.

Audit Plan – Step 4

Employer Responsibilities – (Page 8 of the Whitepaper) – Local Government Audit will prepare template memos that should be **edited** to cover the employer responsibilities listed on page 8. The template memo will be posted on Local Government Audit's website.

Audit Plan – Step 5

Auditing the Schedule of Changes in Fiduciary Net Position – TCRS will prepare a Schedule of Changes in Fiduciary Net Position for each government employer in accordance with the Whitepaper. State Audit will audit and opine on **each** government's individual Schedule of Changes in Fiduciary Net Position as recommended in the Whitepaper. This is Option 2 in the Whitepaper. Local Government Audit will make a copy of State Audit's opinion available on its website.

Other Important Issues

- The above audit plan does not include private pension plans (i.e. pension plans other than TCRS). Similar procedures will need to be considered for private pension plans.

- The AICPA makes it clear that, if Whitepaper guidance is not followed, it will be difficult for employer auditors to obtain sufficient appropriate audit evidence to support amounts reported for the Net Pension Liability, Pension Expense, and Deferred Inflows and Outflows as required under GASB 68.

- Each auditor should read and determine whether the Notes to the Financial Statements provided by the Actuary are reasonable, complete, and agree with information in the Actuarial Report. This process should be documented in the audit workpapers.

- GASB 68's effective date is for fiscal years **beginning** after June 15, 2014, (i.e. July 1, 2014 to June 30, 2015). However, certain Component Units and Utilities have fiscal year end dates that are not June 30 (e.g. September 30). As noted earlier, the TCRS valuation and measurement date for local government employers is June 30, 2014. GASB 68 requires that the measurement date be **no more than one year** from the reporting date. This works perfectly for entities that report a June 30, 2015, year-end. Unfortunately, because of this one year requirement, there is no ideal solution for reporting pension costs for entities that have a fiscal year end **other** than June 30. Some suggestions that might be relevant are as follows:

- The actuarial valuation and measurement date will be June 30, 2014. This cannot be changed for employers under TCRS plans. The actuarial reports based on the June 30, 2014, valuation and measurement information are currently scheduled to be reported by TCRS and its Actuary in February-March 2015. The March 2015 Actuarial information could be applied back to dates such as 9/30/14 and 12/31/14 or applied forward to dates such as 3/31/15 and any date up to 6/30/15. This may necessitate holding a 9/30/14 or 12/31/14 report's release so as to include the March 2015 actuarial reports. In effect, entities that have a fiscal year end prior to June 30, 2015, would be early implementing GASB 68. We realize this is complicated, but this method should avoid a modified opinion. (Unfortunately, some June 30, 2014, reports have already been issued and there are no good options for those governments except to use a similar strategy for June 30, 2015.)

- These entities should consider changing their year-end.

- An opinion could be issued as of June 30 regardless of the normal year-end.

- The difference between September 30, 2015, pension reporting and June 30, 2015, reporting might not be **material**. Auditors will need to consider whether or not a modified opinion is required.

- Questions frequently arise about whether or not Pension Plan Financial Statements should be included in the Financial Statements of a particular government or component unit. The entire issue hinges on the concept of Fiduciary Responsibility. In our judgment, the best explanation of what Fiduciary Responsibility is can be found in a GASB preliminary views document that is currently outstanding titled *Financial Reporting for Fiduciary Responsibility*.

  This document can be obtained at GASB's website: http://www.gasb.org/jsp/GASB/Document_C/GASBDocumentPage?cid=1176164579674&acceptedDisclaimer=true

  While this document is not GAAP yet, it does give CPAs more guidance than is currently available anywhere else.

- Nothing in the previous paragraph is intended to prevent separate reporting for a government and its Pension Plan provided adequate reporting and disclosures are made.

- Some entities have traditionally reported on a FASB or a "special purpose framework" for various reasons. Local Government Audit recommends that all governmental entities be reported on a GASB GAAP basis with the exception of those entities that have a financial reporting framework that is deemed acceptable under existing GAAP (Colleges and Universities, Certain Regulatory Accounting, etc.). Now that GASB 68 calls for the recognition of the Net Pension Liability, the distinction between FASB or other "special purpose frameworks" recognition and

GASB recognition may be too great to overcome for purposes of issuing an unmodified opinion.

- Please advise all your clients that you will be testing census data and that they must have the evidence to support their entries to the TCRS Concord System.

- The above plan specifically relates to TCRS agent multiple-employer plans. TCRS Cost Sharing Plans (Local Education Agency – Teacher Plans) will require similar testing of census data. However, testing of census data will be completed on a rotational basis taking into consideration the size of the proportionate contributions of the cost sharing entities as recommended by SLGEP Whitepaper for *Single-Employer and Cost-Sharing Multiple-Employer Plans: Issues Associated with Testing Census Data in an Audit of Financial Statements*. Annual testing will not be necessary for **all** cost-sharing entities. <u>CPA firms will be notified of those entities that will require testing</u>. Currently, the following school systems are scheduled for testing for the year ending June 30, 2015: Shelby County, City of Alcoa, Benton County, Campbell County, Hamblen County, Hardeman County, Hardin County, Hawkins County, Stewart County, Sumner County, White County, and Williamson County. TCRS and its Actuary will provide allocations of pension costs by entity in accordance with recommendations of the SLGEP Whitepapers.

The testing and other procedures described above will be an ongoing issue for any entity that has a pension plan. CPAs should begin to inform their clients of the new requirements and of any possible increases in audit fees. As noted above, there are also other decisions to consider such as, what date should be utilized for the fiscal year end.

As mentioned above, the Actuarial Reports and Notes to the Financial Statements are tentatively scheduled to be ready sometime in March 2015. Please be advised that this date is subject to change if the Actuary is not finished. This is a very large project involving several parties and many variables. Expect some changes to the above plan as the process unfolds. **Questions about this plan should be directed to Local Government Audit <u>not</u> TCRS.**

Thanks to the efforts of TCRS and State Audit, we will have the opportunity to present most local government financial statements free of modified opinions. It is Local Government Audit's intention to be as understanding as is possible during the implementation and review process. We realize the difficulties the new pension standards impose. We appreciate your efforts in making government in Tennessee work better. We also appreciate the cooperation we have always received from the CPA community. Together we will make it through the implementation of these difficult pension standards. Questions, Comments, and Suggestions should be directed to:

<u>Division of Local Government Audit –</u>

Jerry E. Durham at: Jerry.Durham@cot.tn.gov or 615.401.7951
Or
Rachelle Cabading at: Rachelle.Cabading@cot.tn.gov or 615.401.7953