THE PPC
GOVERNMENTAL UPDATE

Pension Audits—Some More Things to Think About

As you know, there are now a lot of new things to think about when it comes to pension audits. Here are a few points to keep in mind as you begin planning your audits.

First You Need to Answer Some Important Questions

Whether you are auditing the plan itself, or a participating employer, you need to know—

1. Which standards apply (the previous standards or the new standards)?
2. What type of plan is it (defined contribution or defined benefit; single-employer plan, agent multiple-employer plan, or cost-sharing multiple-employer plan)?
3. Is there a special funding situation?

Answers to these questions are important because they establish what must be reported by the plan and participating employers and, accordingly, the focus of auditors' tests.

Which Standards Apply? GASBS No. 67, *Financial Reporting for Pension Plans*, and GASBS No. 68, *Accounting and Financial Reporting for Pensions*, apply to pensions provided through plans that are administered through trusts or equivalent arrangements (trusts) that meet all three of the following criteria:

- Contributions from employers and nonemployer contributing entities are irrevocable.
- Plan assets are restricted to paying pension benefits.
- Plan assets are legally protected from the creditors of employers, nonemployer contributing entities, the plan administrator, and, for defined benefit plans, from plan members' creditors.

Pension benefits provided through trusts that don't meet all of the above criteria will continue to fall under GASBS Nos. 25 and 27.

What Type of Plan Is it? The determination of whether a plan is defined contribution or defined benefit is relatively straightforward—defined contribution

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plans specify the amounts that an employer will contribute to a pension plan during the employee's years of service; defined benefit plans specify the amount of benefits that an employee receives during retirement.

Single-employer Plan or Multiple-employer Plan? Benefits may be provided through either single-employer plans or multiple-employer plans. Multiple-employer plans are further classified as either agent plans or cost-sharing plans. Under an agent plan, the plan's assets are pooled for investment purposes, but each employer's share of the assets can be used only to pay the benefits of its own employees. Under a cost-sharing plan, plan assets can be used to pay the benefits for any employer that provides pensions through the plan.

However, this determination may not be clear-cut. For example, according to both GASBS No. 67, Paragraph 8, and GASBS No. 68, Paragraph 11, a plan that provides pension benefits to a primary government and its component units, but not to other entities, is considered to be a single-employer plan. However, a plan that provides pension benefits not only to the primary government and its component units, but also to other governments that are not component units, is a multiple-employer plan.

Practical Consideration:

Single-employer plans, agent multiple-employer plans, and cost-sharing multiple-employer plans have many different recognition, disclosure, and RSI requirements.

Is There a Special Funding Situation? In a special funding situation, an entity other than the employer (referred to as a "nonemployer contributing entity") assumes a portion of the employer's pension obligation as its own. A special funding situation exists when a nonemployer contributing entity (such as a state government) is legally responsible for making contributions *directly* to a plan that provides pensions to employees of another government (such as a school district) and at least one of the following criteria is met:

- The nonemployer contributing entity is the only entity that has a legal obligation to make contributions directly to the plan.
- The amount of contributions the nonemployer contributing entity is legally responsible for making doesn't depend on a nonpension event. (Nonpension events might exist, for example, when contributions are based on a percentage of a specific revenue source or are for an amount equal to the excess of the nonemployer contributing entity's ending net position above a defined amount.)

Practical Consideration:

In a special funding situation, the nonemployer contributing entity recognizes in its own financial statements its proportionate share of the net pension liability, pension expense, deferred outflows of resources, and deferred inflows of resources related to the employer's pension. The employer reduces the amounts it recognizes by the amounts the nonemployer contributing entity recognizes.

Here's Why Pension Audits Will Be Different Now

GASBS No. 68 significantly changes pension-related amounts, presentation, disclosure, and RSI for governments that participate in defined benefit pension plans. This, in turn, drives changes in the information that plans must present under GASBS No. 67.

GASBS No. 68 represents a huge change in the reporting of pension plans in the employer's financial statements from a *funding-based* or *pay-as-you-go* approach to an *accounting-based* approach. Under GASBS No. 68, the government's net pension liability is treated like any other long-term obligation and moves onto the statement of net position as a liability. The net pension liability is the difference between the actuarial present value of projected benefit payments attributed to past periods of employee service (i.e., the total pension liability) and the plan's net position. Previously, the employer reported a much smaller liability (referred to as a "net pension obligation") that was based on the cumulative difference between the employer's contributions and the annual pension cost (i.e., the annual required contribution, or ARC).

GASBS No. 67, on the other hand, makes only minimal changes to the plan's basic financial statements. It does, however, expand note disclosures and call for new RSI schedules that provide information needed for the employer's financial statements. Information presented in the plan's notes and RSI includes different measures (including total pension liability, net pension liability, and the annual money-weighted rate of return on plan investments) and is based on different measurement approaches than in the past. Only the entry age actuarial cost method with service cost determined as a level percentage of pay can be used. The discount rate used to determine the present value of projected benefits is a blended rate—consisting of the long-term expected rate of return on plan assets and a high-quality municipal bond rate—and is affected by (a) whether plan assets are being invested under a strategy designed to achieve the long-term expected rate of return and (b) when the plan net position is expected to be depleted.

Considering the employer's financial statements, the net pension liability is likely to be one of the largest numbers on its statement of net position. Opining on the net pension liability and other pension-related amounts, such as deferred outflows of resources, deferred inflows of resources, and pension expense; the requirement for expanded disclosures; and the requirement for new RSI all contribute to audit procedures expanding far beyond those necessary for pensions not subject to GASBS No. 68. The problem is compounded when the employer participates in a multiple-employer plan because certain *audited* plan information must be obtained in order for the employer auditor to provide an unmodified opinion on opinion units that report material pension amounts.

Consider for example, that auditing the employer's net pension liability will require obtaining sufficient appropriate audit evidence *for each significant component* of its calculation, including the total pension liability, the plan net position, and the actuarial present value of projected benefits. These components have elements of their own that may need to be addressed by audit procedures. When auditing just the discount rate used to calculate the present value of projected benefits, the auditor may have to perform additional procedures such as—

- Testing a plan net position roll-forward schedule by comparing amounts to the most recent audited financial statements; expected future contributions to current year contributions; expected future benefit payments to actual benefit payments; and investment earnings calculated using the expected long-term rate of return to actual earnings.
- Verifying components of a discount rate calculation schedule by tracing amounts to the net position roll-forward schedule; determining for each year on the discount rate schedule, whether benefit payments should be discounted using the expected long-term rate of return or the municipal bond rate; and testing the mathematical accuracy of the discount rate schedule, including the calculation of the single blended rate, if applicable.

Practical Consideration:

The May, August, and October 2014 editions of this newsletter discussed AICPA whitepapers and auditing interpretations on pension-related audit issues.

What to Do Next

Okay, so you've answered the questions at the beginning of this article. What do you do next? We recommend the following:

- If you haven't done so yet, read GASBS No. 67 and/or GASBS No. 68 (depending on whether you are the plan auditor or the employer auditor).
- If the plan is a multiple-employer plan, download the whitepapers and auditing interpretations from the AICPA's website and read them carefully (**www.aicpa.org/INTERESTAREAS/GOVERNMENTALAUDITQUALITY/RESOURCES/GASBMATTERS/Pages/default.aspx**).
- Watch for more articles in our series of pension-related audit considerations in this newsletter.
- Watch for release of the 2015 update of *PPC's Guide to Audits of Local Governments*, which will provide expanded pension guidance and new practice aids.

GASB Issues Tax Abatement ED

In October 2014, the GASB issued an Exposure Draft of a proposed Statement, *Tax Abatement Disclosures*. The proposed Statement would require disclosure of information about property and other tax abatement agreements by state and local governments.

Why Add Disclosures?

In order to promote economic development, job growth, redevelopment of blighted or underdeveloped areas, and other actions that are beneficial to the government or its citizens, governments may agree to abate or reduce the taxes of businesses and other taxpayers. The proposed Statement requires disclosures on tax abatements whether issued by the reporting government or initiated by another government that reduces the reporting government's tax revenues. The proposed Statement defines tax abatement for financial reporting purposes as the result of an agreement between a government and a taxpayer where the government promises to forgo tax revenues and the taxpayer promises to take a specific action that contributes to economic development or provides some type of benefit to the government or its citizens.

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Tax abatement programs in place at many state and local governments can have a substantial impact on a government's ability to raise revenue and its financial health. The magnitude and nature of the effect from such tax abatement programs can be difficult to determine in financial statements available in today's environment.

What Are the Disclosures?

The proposed Statement adds new disclosures in the notes to the financial statements that should provide essential information about tax abatement programs. The proposed Statement provides several general principles for the disclosures. The proposed disclosure requirements would include—

- *General Descriptive Information.* The general descriptive information consists of the name and purpose of the tax abatement program(s), tax being abated, the authority that the tax abatement agreement is created under, the criteria that must be met for the taxpayer to be eligible for the abatement, the method in which the taxes are abated, provisions for recapturing abated taxes, and the types of commitments made by the recipient of the tax abatement.
- *Number of Tax Abatement Agreements.* The disclosures will include the number of tax abatement agreements that originated during the reporting period and that were in effect as of the end of the reporting period.
- *Amount of Taxes Abated.* The notes will disclose the total reduction of the reporting government's tax revenues during the reporting period because of tax abatement agreements.
- *Other Commitments Made by a Government.* The disclosures will provide a description of any types of commitments other than the reduction of taxes, such as to build infrastructure assets, made by the reporting government as part of tax abatement agreements and the most significant individual commitments that are not to reduce taxes, if any, made by the reporting government as part of tax abatement agreements. The information regarding commitments not related to tax reductions should be disclosed until the reporting government fulfills the commitment.

Proposed Effective Date

The proposed requirements would be effective for financial statements for fiscal years beginning after December 15, 2015, with earlier application encouraged.

Practical Consideration:

The Exposure Draft is available on Checkpoint and at **www.gasb.org**.