The Governmental Accounting Standards Board’s (GASB’s) two new pension standards will increase complexity for auditors as well as for employers and plans. These new challenges are the result of GASBS No. 67, Financial Reporting for Pension Plans, and GASBS No. 68, Accounting and Financial Reporting for Pensions (which became effective for years beginning after June 15, 2013 and June 15, 2014, respectively).

**Observation:** GASBS Nos. 67 and 68 did not supersede the previous standards for all plans. Certain plans still fall under the requirements of GASBS No. 25, Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans, and No. 27, Accounting for Pensions by State and Local Governmental Employers. (See “Which Standards Apply?” below.)

This special report provides general considerations on governmental pension plans, narrows the focus to accounting considerations related to GASBS No. 68 and addresses critical auditing considerations. The special report addresses defined benefit pension plans, which are the majority of plans. Although these two new standards address both defined contribution plans and defined benefit plans, their most significant changes relate to defined benefit pension plans.

**DEFINED BENEFIT PENSION STATISTICS**

So, how many plans and how much money are we talking about? The short answer — a lot! The U.S. Census Bureau reports there were almost 4,000 defined benefit pension systems covering more than 19 million plan members and receiving more than $100 billion of contributions from governments at the end of the 2012 fiscal year.

<table>
<thead>
<tr>
<th>Type of Government</th>
<th>Number of Systems</th>
<th>Total Plan Members</th>
<th>Total Contributions (in billions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>State</td>
<td>227</td>
<td>2,043,058</td>
<td>$ 42.7</td>
</tr>
<tr>
<td>Local</td>
<td>3,771</td>
<td>17,544,912</td>
<td>$ 58.3</td>
</tr>
<tr>
<td>TOTAL</td>
<td>3,998</td>
<td>19,587,970</td>
<td>$ 101.0</td>
</tr>
</tbody>
</table>

* Amounts shown do not include employee contributions totaling $43.5 billion.
GENERAL CONSIDERATIONS

GASBS No. 68 represents a huge change in the reporting of governmental pension plans in the financial statements of the employer from a funding-based or pay-as-you-go approach to an accounting-based approach. The net pension liability is now treated like any other long-term obligation of the government and moves onto the statement of net position as a liability, which will also result in an acceleration of expense recognition as compared to the previous standards.

Observation: Under GASBS No. 68, 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 applies to the plans’ financial statements, rather than the employers’ financial statements. However, it expands note disclosures and calls for new required supplementary information (RSI) schedules. Information presented in the 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. The entry age actuarial cost method with service cost determined as a level percentage of pay is required to be used for reporting purposes. 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 whether investments are being invested under a strategy designed to achieve the long-term expected rate of return and when the plan net position is expected to be depleted.

You Need to Know the Answers to These Questions

Three key questions must be answered in order to properly plan the audit of the plan’s or the employer’s financial statements:

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

Observation: Answers to these questions are important because they establish what must be reported by the plan and participating employers and, accordingly, the focus of the auditor’s tests.

Which Standards Apply? GASBS Nos. 67 and 68 apply to pensions provided to the employees of state and local governments through plans that are administered through trusts or equivalent arrangements 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 or other arrangements that don’t meet all of the above criteria will continue to fall under GASBS Nos. 25 and 27.
**Observation:** The determination of whether a particular trust meets the criteria may not be straightforward. For example, the GASB Guide to Implementation of GASB Statement 68 on Accounting and Financial Reporting for Pensions, Questions 10 and 11 address the situations in which (1) a trust agreement provides a reversionary right for all amounts remaining in the trust after all obligations have been paid to be returned to the employer and (2) a trust agreement provides for the return of plan assets to the employer if the funded status of the plan reaches a certain level. In situation (1), the plan is considered to be administered through a trust that meets the criteria and the employer would apply GASBS No. 68. However, in situation (2), the trust doesn’t meet the criteria and the employer would apply GASBS No. 27.

**What Type of Plan is it?** Defined benefit plans provide benefits through either single-employer plans or multiple-employer plans. Only large local governments tend to have single-employer plans. Many states administer multiple-employer plans for local governments within the state. 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 pension benefits for any employer that provides pensions through the plan.

**Observation:** Again, this determination may not be clear-cut. For example, GASBS No. 68, paragraph 11 indicates 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.

**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 non-pension event.

**Observation:** According to the GASB Guide to Implementation of GASB Statement 68 on Accounting and Financial Reporting for Pensions, Questions 25 and 27 having been identified in the past as being responsible for making contributions directly to a plan is not equivalent to having a legal obligation to make contributions. Legal obligations arise through constitutions, statutes, charters, ordinances, resolutions, governing body orders or intergovernmental grant or contract regulations. For purposes of the second criterion, non-pension events that would prevent a government from meeting the criterion might be, 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. Pension events that allow a government to meet the second criterion include statutorily required contributions that are a percentage of covered payroll or a percentage of the employer’s required contributions.

**ACCOUNTING CONSIDERATIONS UNDER GASBS NO. 68**

As noted previously, the implementation of GASBS No. 68 represents a huge change in the reporting of governmental pension plans in the financial statements of the employer from a funding-based or pay-as-you-go approach to an accounting-based approach. While adding a large net liability to the statement of net position may give the appearance that the government is financially weaker than it was under the previous standards, its underlying economic situation will not have changed at all — only its presentation will have changed.
The following table highlights certain key considerations in applying GASBS No. 68 and some of the differences from the current standards:

<table>
<thead>
<tr>
<th>AREA</th>
<th>NEW REQUIREMENT</th>
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<tbody>
<tr>
<td><strong>Total pension liability</strong> — the portion of the actuarial present value of projected benefit payments that is attributed to past periods of employee service</td>
<td>As before, the measurement of projected benefit payments should include the effects of automatic postemployment benefit changes, including automatic cost-of-living adjustments (COLAs). However, unlike previous standards, expected ad hoc COLAs and other ad hoc benefit changes should be included only if the government makes them with such regularity that they are, in effect, automatic.</td>
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<tr>
<td></td>
<td>Previously, the discount rate used to discount projected benefit payments to their present value was based on an estimated long-term investment rate of return. However, under GASBS No. 68, the discount rate may be a blended rate based on a combination of the long-term expected rate of return and a municipal bond rate [a yield or index rate for 20-year, tax-exempt general obligation municipal bonds with an average rating of AA/Aa or higher (or equivalent quality on another rating scale)]. That would be the case when projected benefit payments aren’t fully covered by the plan’s net position and projected contributions. Determination of the blended rate requires calculating the actuarial present value of projected benefit payments in a two-phase process:</td>
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<td></td>
<td>(1) The long-term expected rate of return is applied to the portion of plan assets for which the plan’s net position plus projected contributions are expected to fully cover projected benefit payments.</td>
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<tr>
<td></td>
<td>(2) The municipal borrowing rate is applied beginning at the crossover point where projected benefit payments exceed plan net position plus projected contributions. Accordingly, the discount rate is the single blended rate of return that, when applied to all projected benefit payments, achieves the actuarial present value equal to the total of (1) and (2).</td>
</tr>
<tr>
<td>The entry age actuarial cost method must be used to allocate the present value of the projected benefits of each individual employee over past, present and future employee service, starting from when the employee first begins to earn benefits. For this purpose:</td>
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</tr>
<tr>
<td></td>
<td>• Each employee’s service costs should be allocated as a level percentage of his or her projected pay.</td>
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<td></td>
<td>• Service costs should be attributed through all assumed exit ages through retirement.</td>
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<tr>
<td></td>
<td>• Each employee’s service costs should be determined based on the same benefit terms reflected in the actuarial present value of his or her projected benefit payments. Under previous standards, several actuarial cost methods could be used (entry age, frozen entry age, attained age, frozen attained age, projected unit credit or aggregate). Also, the two classes of cost methods used to allocate the actuarial present value of projected plan benefits to periods of employee service were (1) the cost-allocation method, which results in a normal cost that remains level over time when expressed as a percentage of payroll or (2) the benefit-allocation method, which produces increasing normal cost rates that progress for individual participants.</td>
</tr>
</tbody>
</table>
### Net pension liability/asset

For the first time, the difference between the total pension liability and the plan net position (i.e., the net pension liability or net pension asset) will appear plainly on the face of the financial statements. When the total pension liability exceeds the plan net position (which usually happens), the government reports that excess in its accrual-based financial statements as net pension liability. When the plan net position exceeds the total pension liability (which rarely happens), the government reports a net pension asset.

### Calculation of pension expense

Generally, the overall effect of the new requirements will be that pension expense will be reported sooner than it was under the previous standards. Previously, the effects of changes in benefit terms, changes in assumptions, experience gains and losses and the difference between assumed and actual earnings were introduced into expense in increments over selected periods of up to 30 years. However, under GASBS No. 68:

- Items included in the calculation of pension expense in the period that they cause a change in the net pension liability are: (1) benefits earned, (2) interest on the total pension liability, (3) changes in benefit terms, (4) projected earnings on plan investments and (5) changes in plan net position from items other than investments.
- The effects on the total pension liability of changes in assumptions and differences between assumptions and actual experience are initially recognized as deferred outflows of resources or deferred inflows of resources. They are factored into expense over the average remaining years of employment for all active and inactive employees, including retirees.
- The difference between expected and actual earnings on plan investments is initially recognized as a deferred outflow of resources or deferred inflow of resources and included in expense over a five-year closed period.

### Reporting — cost-sharing plan

For the first time, a government that participates in a cost-sharing plan must report a net pension liability, pension expense, deferred outflows of resources and deferred inflows of resources based on its proportionate share of the collective amounts for all governments participating in the plan.

### Disclosures and RSI

#### Disclosures — overall changes

Required disclosures have significantly changed to provide users of the employer's financial statements with certain basic financial information about the plan.

#### Disclosures — all governments

All employers must now disclose the following:

- A description of the plan and benefits provided
- Significant assumptions used in the measurement of the net pension liability
- Descriptions of any changes in benefits or assumptions
- Discount rate assumptions
- Impact on the total pension liability of a one percentage point increase and a one percentage point decrease in the discount rate
- Net pension liability
- Deferred outflows of resources and deferred inflows of resources
### Disclosures and RSI

<table>
<thead>
<tr>
<th>AREA</th>
<th>NEW REQUIREMENT</th>
</tr>
</thead>
</table>
| Disclosures — single and agent employers | Disclosures must also include for the current period:  
  - Beginning and ending balances of the net pension liability  
  - Effects of changes during the year (e.g., the effects of service cost, benefit changes and actual investment earnings) |
| RSI — overall | RSI has been expanded to provide users of the employer’s financial statements with certain basic financial information about the plan. |
| RSI — all governments that have an actuarially (or statutorily) determined annual contribution | An RSI schedule that has the following information for each of the past ten years must be presented:  
  1. Actuarially (or statutorily) determined annual pension contribution  
  2. Amount of employer contribution actually made  
  3. Difference between (1) and (2)  
  4. Payroll of employees covered by the plan  
  5. Ratio of (2) divided by (4) |
| RSI — single and agent employers | An RSI schedule that has the following information for each of the past ten years must also be presented:  
  - Beginning and ending balances of the total pension liability, the plan’s net position, the net pension liability and the components of each  
  - Total pension liability, the plan’s net position, net pension liability, the ratio of the plan’s net position to the total pension liability, covered-employee payroll and the ratio of the net pension liability as a percentage of the covered-employee payroll |

### Special Funding Situation

<table>
<thead>
<tr>
<th>AREA</th>
<th>NEW REQUIREMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognition by nonemployer contributing entity</td>
<td>A 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 pensions.</td>
</tr>
<tr>
<td>Recognition by benefitting government</td>
<td>A government that benefits from a nonemployer contributing entity’s contributions calculates the net pension liability, pension expense, deferred outflows of resources and deferred inflows of resources before the nonemployer contributing entity’s support but recognizes only its own proportionate share of those amounts in its financial statements.</td>
</tr>
</tbody>
</table>

Based on these new requirements, certain information needed for the employer’s financial statements has to be obtained from the plan itself. As noted previously, to facilitate the transfer of information, GASBS No. 67 requires the plan’s financial statements to include new schedules and disclosures.
AUDITING CONSIDERATIONS

An employer’s net pension liability is likely to be one of the largest numbers on the government’s statement of net position. Opining on it as well as other pension related amounts (such as deferred outflows of resources, deferred inflows of resources and pension expense) as well as the requirements for expanded disclosures and new RSI, all contribute to expanding audit procedures beyond what is necessary for pensions not subject to GASBS No. 68. The problem is compounded when the employer participates in a multiple-employer plan because, as discussed further below, 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.

Auditing the net pension liability requires 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.

For example, when auditing the discount rate used to calculate the actuarial 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 and comparing 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 the 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

Observation: Auditors might want to consider using an actuary as an auditor’s specialist on the audit engagement. Previously, the government or the plan would have had an actuary involved as a management’s specialist. In the government environment, however, the auditor did not typically use an actuary as an auditor’s specialist when auditing amounts reflected in the financial statements under the earlier standards.
AICPA Whitepapers and Auditing Interpretations
Although the GASB has issued these complex new standards, it isn’t their purview to tell auditors how to audit them. Recognizing the challenges facing auditors, the AICPA has issued the following whitepapers and auditing interpretations, primarily addressing the additional complexities involved with multiple-employer plans:

- **Whitepapers:**
  - “Governmental Employer Participation in Cost-Sharing Multiple-Employer Plans: Issues Related to Information for Employer Reporting”
  - “Governmental Employer Participation in Agent Multiple-Employer Plans: Issues Related to Information for Employer Reporting”

- **Auditing Interpretations:**
  - Interpretation No. 2, *Auditor of Participating Employer in a Governmental Cost-Sharing Multiple-Employer Pension Plan*, of AU-C 500, *Audit Evidence*
  - Interpretation No. 3, *Auditor of Participating Employer in a Governmental Agent Multiple-Employer Pension Plan*, of AU-C 500, *Audit Evidence*
  - Interpretation No. 1, *Auditor of Governmental Cost-Sharing Multiple-Employer Pension Plan*, of AU-C 805, *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*
  - Interpretation No. 2, *Auditor of Governmental Agent Multiple-Employer Pension Plan*, of AU-C 805, *Special Considerations — Audits of Single Financial Statements and Specific Elements Accounts, or Items of a Financial Statement*
The whitepapers and auditing interpretations can be downloaded from the AICPA's website at: www.aicpa.org/INTERESTAREAS/GOVERNMENTALAUDITQUALITY/RESOURCES/GASBMATTERS/Pages/default.aspx.

The following are examples of recommendations in the whitepapers:

- **Cost-sharing plan:**
  - The plan should prepare a schedule that calculates each employer’s allocation percentage, for example, a schedule based on actual employer contributions for which the plan auditor is engaged to issue an opinion (full opinion, not an in-relation-to opinion).
  - The plan should prepare a schedule of pension amounts (net pension liability, deferred outflows of resources by category, deferred inflows of resources by category and pension expense) per employer. The plan auditor would be engaged to provide an opinion on each element of the schedule and report on the schedule in accordance with AU-C 805, *Special Considerations — Audits of Single Financial Statement and Specific Elements, Accounts or Items of a Financial Statement*.
  - Underlying census data would be tested using a risk-based approach for selecting employers for testing at the employer’s location.
  - The employer’s auditor may test certain underlying census data in accordance with the Statements on Standards for Attestation Engagements (AT 101, *Attest Engagements*). (The plan auditor would still have to select the employers to be tested.)

- **Agent plan:**
  - The plan actuary would issue a separate actuarial report for each participating employer that includes the net pension liability, deferred outflows and inflows of resources by category and year, pension expense and the discount rate calculation. The plan auditor would be engaged to either issue a service organization controls 1 (SOC 1) report on controls over census data maintained by the plan or an examination report on plan management’s assertions related to census data maintained by the plan.
  - The plan should prepare a schedule of changes in fiduciary net position by employer for which the plan auditor would be engaged to either provide an opinion on the schedule as a whole or to issue a SOC 1 report on allocations of additions and deductions to individual employer accounts. Alternatively, the plan auditor might be engaged to provide an opinion on the schedule as a whole and on each individual employer column.
Interpretation Nos. 1 and 2 of AU-C 805 clarify that the schedules recommended in the whitepapers may be audited by plan auditors under AU-C 805 because they are elements or items of the plan or the employer’s financial statements. Interpretation Nos. 2 and 3 of AU-C 500 point out that employer auditors are solely responsible for determining the sufficiency and appropriateness of audit evidence for pension amounts included in the employer financial statements. However, without this additional audited information provided by the multiple-employer plans as evidence that the pension amounts allocated to the employer are not materially misstated, it is unlikely that employer auditors can provide unmodified opinions on opinion units with material pension amounts.

If the information is available to be used as audit evidence, Interpretation No. 1 of AU-C 600 points out that the employer auditor may not make reference to the audit report of the plan auditor because the plan is not a component of the employer. Instead, the employer auditor should:

- Evaluate whether the plan auditor’s report and accompanying schedules are adequate and appropriate for their use
- Evaluate whether the plan auditor has the necessary competence and independence
- Verify and recalculate amounts for the specific employer in the plan’s schedules

**Observation:** Any problems with the above procedures may result in the plan’s schedules not being considered sufficient and appropriate audit evidence resulting in a modified opinion on the appropriate opinion unit by the employer auditor.

**NEXT STEPS**

As previously mentioned, GASBS Nos. 67 and 68 became effective for years beginning after June 15, 2013 and June 15, 2014, respectively. While auditors of plan financial statements have already been addressing the new requirements related to GASBS No. 67 in their clients’ June 30, 2014 financial statements, auditors of employer governments most likely won’t be auditing the new pension amounts and disclosures until years ending June 30, 2015. However, now is the time for auditors to begin communicating with the employer’s management and with plan administrators to ensure that the recommended audited plan information will be available for the employer’s audit. If such information won’t be available, auditors should start educating their clients on how the opinions on certain opinion units might be modified because of the missing audit evidence.
RELATED GUIDANCE

The Tax & Accounting business of Thomson Reuters provides several resources to help you navigate the complex maze of the GASB's new pension standards, including guidance in the following:

**PPC’s Guide to Audits of Local Governments**
Local government audits require specialized guidance and tools to address their unique audit and accounting requirements. The 2015 edition of PPC’s Guide to Audits of Local Governments will provide the audit programs, checklists, confirmations and auditor’s reports you need to correctly perform these audits in an effective and efficient manner, from regular GAAS audits to Government Auditing Standards (Yellow Book) audits to Single Audits.

**PPC’s Practice Aids for Audits of Local Governments**
PPC’s Practice Aids for Audits of Local Governments are Word and Excel versions of all editable practice aids included in PPC’s Guide to Audits of Local Governments.

**PPC’s Guide to Preparing Governmental Financial Statements**
PPC’s Guide to Preparing Governmental Financial Statements is the one source for answers on applying GAAP to a government. The guide is a hands-on resource that discusses and illustrates governmental accounting standards and can best be described as a governmental GAAP guide.

**PPC’s Interactive Disclosure Library for Local Governments**
PPC’s Interactive Disclosure Library for Local Governments provides an electronic version of the disclosure checklist for governmental entities along with disclosure examples that illustrate the disclosures required by GAAP.

**The PPC Governmental Update Newsletter**
The PPC Governmental Update Newsletter is a monthly newsletter that keeps readers up-to-date on matters affecting local governments and their auditors.

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