



Dave Yost • Auditor of State

AUDIT DIVISION ADVISORY MEMO 2015-04

TO: Audit Division Staff, Clerk of the Bureau
FROM: Center for Audit Excellence and Local Government Services
DATE: December 3, 2015
RE: **AICPA State & Local Government Expert Panel (SLGEP) – Evidence supporting Opening Balances for Net Pension Liability and Employer Pickup**

AICPA Article Highlights

An October SLGEP article reminds us that AU-C 510 (sic) requires sufficient, appropriate evidence supporting opening balances (in this case the opening NPL) to support our opinions on statements reporting the annual change in NPL in the year of adopting GASB 68. The article suggests obtaining an opinion on two schedules to support the opening NPL: (1) employer allocations and (2) opening NPL.

This section of the article concludes:

“Without the plan addressing the opening balances as described above, it is unlikely that the employer auditor could meet the requirements of AU-C section 510. Some have asserted that the recommended approach is not necessary as the plan auditor has, in essence, substantiated the beginning net pension liability because they have audited the current year schedule of pension amounts, which includes ending net pension liability and the changes in net pension liability (NPL) for the year (i.e., Ending NPL + Decreases in NPL – Increases in NPL = Beginning NPL). However, because the increases and decreases in net pension liability are based on the measurement of net pension liability at the beginning and end of the year, additional evidence that supports the beginning net pension liability and its allocation to the employers is necessary.”

Impact on Each Ohio Pension System

GASB 68 allows the NPL to be measured as of a date no earlier than the end of the employer's prior fiscal year. Due to the timing of the availability of the information from the pension systems, many entities will elect to use a measurement date as of the prior fiscal year end. Meaning schools with a fiscal year end of June 30, 2015, will be reporting the June 30, 2014, NPL as their ending balance and the July 1, 2013 balance as their beginning balance.

STRS and OPERS

For the Ohio Public Employees Retirement System (OPERS) and State Teachers Retirement System (STRS), the Independent Public Accountant who audited these pension systems' schedules issued an unmodified opinion on the opening balances for the net pension liabilities. Therefore, we need

only evaluate whether the number of school employees participating in these pension systems has significantly changed since the previous year. We included guidance to auditors about these evaluations at the end of this memo.

The Independent Public Accountant who audited the School Employees Retirement System (SERS) and Ohio Police & Fire (OP&F), however, did not opine on the opening balances for the net pension liabilities. Therefore, we must perform additional analysis over the opening balances for SERS and OP&F to determine whether we believe they are materially accurate.

SERS

We have carefully considered the concerns expressed in AU-C-510 above (i.e. that it is insufficient to deduce the opening NPL by mathematically backing into it.) We agree, but this memo explains why we have considerably more (and *audited*) evidence than the aforementioned mathematical exercise for SERS. We therefore conclude existing evidence is sufficient and appropriate, and we need not incur the cost to the taxpayers of the suggested opinion for SERS.

The SERS' July 1, 2013 (opening—FY15 beginning balance measurement date) NPL of \$5.946 billion is the total pension liability per the actuaries less the plan net position at June 30, 2013 as presented in SERS' CAFR at June 30, 2013. The July 1 investments agree exactly to the investments as of June 30, 2013 in SERS' CAFR. The firm of McGladrey unquestionably audited these investments.

But what about the pension liability?

The total pension liability agrees with the actuarial accrued liability reported in Note 12 of SERS' June 30, 2013 statements, also audited by McGladrey. (The actuarial accrued liability is the sum of the Pension Trust, Medicare B and Death Benefit Funds' actuarial accrued liabilities.) The liability was not adjusted, because SERS used the same assumptions and also the entry-age method GASB 68 requires.

We believe the audit assurance on the opening actuarial liability and plan net position renders the need for another opinion redundant.

OP&F

Unfortunately, the opening NPL for OP&F did not agree to the December 31, 2013 NPL reported in the audited financial statements. While not required under the reporting standards applicable to this period, OP&F did not use the entry-age actuarial method for computing the December 31, 2013 NPL. However, with the application of GASB 68, pension systems are only permitted to use the entry-age actuarial method in computing the NPL. Absent an opinion from OP&F's Independent Public Accountant on the opening NPL, local government auditors will have to perform alternative procedures to gain assurances over the opening NPL for their government auditees. AOS will provide more guidance on possible alternative procedures in a future communication.

Evaluating the Need to Propose Adjustments to Opening Balances

The final component of the opening NPL is the allocation percentage each employer must use to compute its proportionate share. We intend to use the same percentages used for the end-of-year allocation. Given the stability of almost all employers, this will be sufficiently accurate in most

instances. AOS auditors should evaluate whether the employer's "head count" has changed by more than 10% from the numbers used for the end-of-year allocation. Only if there is a greater than 10% variance in the number of employees, AOS auditors should further evaluate whether there is also more than a 10% variance in the amount of the *employer* contributions from 2013 to 2014. The amount for the employer contributions can be found in the RSI table for contributions that displays employer contributions by year. AOS auditors should consult with the Center for Audit Excellence (CFAE) if both an employer's "head count" and the employer contributions have changed by more than 10% from the previous year. The CFAE will work cooperatively with the regional AOS auditors to determine whether it may be necessary to adjust the opening balance based upon other factors that may be unique to each entity. If deemed necessary, one option for computing an adjustment might be to multiply the eight-digit proportionate share times the ratio of opening head count divided by ending head count. CFAE may also suggest additional factors on a case-by-case basis for AOS auditors and the local government entities to consider as well in determining the materiality or computation of adjustments.

Employer Pick Up

The AICPA article also discusses the accounting treatment for employer pension pick-up, linking financial reporting to certain Internal Revenue Code (IRC) requirements. Footnote 2 of GASB 68 provides the following guidance:

In some circumstances, contributions are made by the employer to satisfy employee contribution requirements. If the contribution amounts are recognized by the employer as salary expense, those contributions should be classified as employee contributions for purposes of this Statement. Otherwise, those contributions should be classified as employer contributions.

In their article, the AICPA interpreted GASB 68 footnote 2 as requiring the accounting for employer pension pickups to follow the IRC regulations. That is, if the IRS views the contributions as *employer* contributions, so should the employer's financial statements. Pursuant to IRC 414(h)(2), where employers make an election to provide employee pick up on retirement, the employee contribution is viewed by the IRS to be an *employer* contribution. Under the IRC, this election is required for both the salary reduction method (i.e., to make the contributions pre-tax) and the salary supplement method (i.e., the employer pays a portion of the employee share). In Ohio, we believe the majority of local governments have the salary reduction method of pick up at a minimum. We are aware that some governments, although possibly only a few, also have the salary supplement pick up as well, particularly in administrator and treasurer's contracts.

In Ohio, most of the employers use the salary reduction method to record the employee contribution as part of salary expense, consistent with the GASB guidance above. For the employers using the salary supplement method, the pick-up was generally given in lieu of a salary increase. Thus, we believe viewing the employer pick up in these two examples as salary expense is reasonable. If a local government believes the employer pick-up is not related to salary, the local government may consider reporting the pick-up as the *employer's* contribution. However, it may be difficult to ascertain the original intent of the employer pick up in some cases. Where this is the case, we suggest evaluating whether the employer pick up could be material to the local government's financial statements.

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At GASB's October 26, 2015 board meeting, the board discussed potential changes in accounting for employer paid member contributions and formed tentative conclusions for the employer to classify pick-up (both salary reduction and salary supplement plans) as salary expense. This decision could be changed by a vote of the GASB board; it is also subject to GASB's due process. An exposure draft on the *Pension Benefit Issues* project will be issued on the subject with a pronouncement scheduled for release March 2016. This decision is not final, but it does provide direction on the path the GASB is currently heading.

While the AICPA's article seemingly contradicts the GASB's decision, we believe reporting the employer pick-up as *salary expense* is in line with current GAAP and consistent with the clarifications GASB plans to make in their March 2016 pronouncement. Therefore, our LGS division will be using this approach in their compilation and review services. However, in light of the AICPA article, AOS auditors should accept an alternative approach that is well-reasoned and adheres to the guidelines specified by the article until or unless the GASB issues its final pronouncement prescribing a particular accounting method for employer pick-ups.

Please contact your CFAE consultants for further questions regarding the information in this Advisory Memo.