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STATE AND LOCAL GOVERNMENT FINANCE DIVISION
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Memorandum #2015-06

TO: **Local Government Finance Officials and Their Independent Auditors**

FROM: **Sharon Edmundson, Director, Fiscal Management Section**

SUBJECT: **GASB Statement 67, *Financial Reporting for Pension Plans*, and GASB Statement 68, *Accounting and Financial Reporting for Pensions***

DATE: **December 1, 2014**

Earlier this year, we published Memorandum #2014-12 which introduced Governmental Accounting Standards Board (GASB) Statements 67, *Financial Reporting for Pension Plans*, and 68, *Accounting and Financial Reporting for Pensions*. These statements change the financial reporting requirements for pension plans (Plan) and participant employers in certain defined benefit pension plans. At that time, many of the details regarding the implementation of these two statements, particularly Statement 68, were not yet defined. This document will focus primarily on implementation of GASB 68 and the four multi-employer cost-sharing defined benefit plans that enroll local governments and public authorities – the Teachers and State Employees Retirement System (TSERS), the Local Government Employees Retirement System (LGERS), the Firefighters' and Rescue Squad Workers' Pension Plan (Fire and Rescue) and the Register of Deeds' Supplement Pension Plan (RODSPP).

Of these four plans, the Fire and Rescue Plan is the only one that also has been determined to be a special funding situation. A special funding situation arises when a nonemployer entity (other than the employee) is legally responsible for making contributions directly to a pension plan that is used to provide pensions to the employees of another entity. While the Fire and Rescue plan benefits certain employees of local governments, only the State is required to make contributions directly to the plan, other than those contributions made by the employees.

As we have stated in other publications about these new standards, it is important to remember that these are accounting and reporting standards. They will change the way we account for and report on defined benefit pension plans at the government-wide and full accrual levels of reporting. They will not change the way we fund our pension plans. Units that are members of LGERS and TSERS will still make monthly contributions as percentages of eligible payroll and will still withhold and remit the required percentages from employees' salaries.

The most obvious change resulting from implementation of Statement 68 will be that the participant employers will record their proportionate share of the plan's net pension asset or liability in their full accrual financial statements. Previously financial reporting centered on the employer's Unfunded Actuarial Accrued Liability, which was only a disclosure item; Statements 67 and 68 move the focus from funding the Annual Required Contribution (ARC) to reporting the employer's share of the net pension asset or liability, pension expense, and deferred inflows and outflows of resources.

GASB 67 was implemented with the Plan's June 30, 2014 statements. GASB 68 will be implemented in the participant employer's financial statements for the fiscal year beginning after June 15, 2014. For most units, this will be in the June 30, 2015 audited financial statements. It is important to note that the participant employers will be heavily reliant on the Plan for the detailed financial information that will be disclosed in the participant employers' audit reports. We expect that the relevant data will be available for participant employers in the spring of each calendar year. This should provide sufficient time to prepare the data for inclusion in the audited financial statements. Also, please remember that almost all of the data needed to comply with the new reporting requirements will be provided by the Plan and shown in our illustrative financial statements.

Though almost all of what will be presented in the financial statements will be provided by the Plan, it is important to conceptually understand what will change. To facilitate comprehension of the new terms and concepts associated with the new reporting requirements, we encourage you to familiarize yourself with the statements' glossaries. The more significant terms and concepts are outlined below. For purposes of this memo, we will assume that calculation of the net position of the Plans will result in a net pension liability. The actual calculations for the Plans may result in a net pension asset in any given Plan.

Total Pension Liability (TPL) – This will represent the gross liability of the pension plan. It will include service cost, interest, any differences between expected and actual experience as it relates to earnings or payments of the plan, and any payments made to members. The TPL will be determined at the measurement date.

Net Pension Liability (NPL) – This is the Total Pension Liability less the Plan's net position. The NPL will be allocated to all participant employers as of the measurement date. Again, this could be a Net Pension Asset.

Pension Expense – In prior years, pension expense was the contribution made by employers to satisfy the ARC. With the new model, pension expense will be the annual change in the Net Pension Liability (NPL). There will be some components of pension expense which will be immediately recognized and some that will be deferred and recognized in future years.

Average expected remaining service life of active and inactive employees – an actuarially determined figure that is used to define the period over which the deferred recognition components of pension expense will be recognized. Currently it is just under six years.

Valuation Date – date on which the TPL is actuarially valued (December 31, 20XX)

Measurement Date – date on which the NPL is measured (June 30, 20XY)

Pension Expense

The components of pension expense that will be immediately recognized are -

- Service cost – the value of new benefits earned each year
- Interest on the TPL
- Changes in benefit terms – increases or reductions in benefits to retirees
- Investment earnings on plan assets

Several components of pension expense will be recognized over several years as deferred inflows or deferred outflows. These are:

- Differences between expected and actual experience with regard to economic or demographic factors (differences between expected and actual experience) in the measurement of the total pension liability; this will be a deferred outflow recognized in pension expense over the average remaining service life of active and inactive employees.
- Changes of assumptions about future economic or demographic factors or of other inputs (changes of assumptions or other inputs); this will be a deferred outflow recognized in pension expense over the average remaining service life of active and inactive employees.
- Difference between projected and actual earnings on plan investments; this will be a deferred outflow or a deferred inflow and will be recognized in pension expense over a closed five year period.
- The difference between the employer's actual contributions to the plan and the employer's proportionate share of all contributions to the plan; this will be a deferred outflow or inflow recognized in pension expense over the average remaining service life of active and inactive employees.
- Change in proportionate share; this will be a deferred inflow or deferred outflow of resources recognized in pension expense over the average remaining service life of active and inactive employees.
- Employer contributions made subsequent to the measurement date and before the employer's fiscal year end will be reported as a deferred outflow.

The pension expense and all the deferrals (except the contributions made during the gap period and the deferral for the change in the percentage share for each employer participant – see the next two paragraphs) will be calculated at the Plan level and allocated to the participant employers along with the net pension liability or asset. These allocations will be made based on the individual participant employer's proportionate share as determined using a methodology to be determined. The State's actuary will make the required calculations for the proportionate share figures.

With one or two exceptions, depending on the allocation method chosen, the deferral amounts will be provided to each participant employer annually. The State's actuary will provide the deferral amounts and will track the amortization for each participant employer on an annual basis. One exception will be employer contributions to the Plan for the period between the measurement date (June 30, 20X0) and the fiscal year end, defined as the gap year (for most units June 30, 20X1). **Participant employers will have to track their own contributions to the Plan during the gap period. These contributions will be reported as a deferred outflow of resources. Units with alternative fiscal year ends will have a gap period that begins on July 1,**

20X1 and ends on their fiscal year end (September 30, 20X1, December 31, 20X1 or March 31, 20X2).

The second exception, if applicable, will be the deferral for the difference between actual contributions during the measurement period and the employer's proportionate share of contributions in total during the same measurement period. Once a methodology for determining proportionate share is determined, we will provide further details on calculating and tracking deferrals.

Please note that for the Firefighters' and Rescue Squad Workers' Pension Fund, a special funding situation, participant employers will record an additional revenue and expense for the proportionate share that the State contributed and the proportionate share of deferrals.

Note Disclosures

Not surprisingly, there will be additional note disclosure requirements with the implementation of GASB 68. To reiterate, most of the data for the note disclosures will be provided by the Plan, and the State and Local Government Finance Division, SLGFD, will provide sample text and templates. Participant employers will only have to customize the notes for each unit.

For cost-sharing plan participants the following will have to be disclosed in the notes to the financial statements –

- Description of the Plan, the benefits provided, and contribution requirements
- The fact that the Plan does not issue a separate report but that it is included in the State's CAFR and how one can access a copy
- Any assumptions used to measure TPL
- Elements of the Plan's financials and fiduciary net position, by reference to the State's CAFR
- Participant employer's share of NPL
- Any change in the allocation proportion subsequent to prior measurement date
- Measurement date, valuation date, and a statement that update procedures were used to roll the liability forward to the valuation date
- Description of any changes in assumptions since the prior measurement date that affect the measurement of the TPL
- Description of changes between the current measurement date and the employer's reporting date that will affect the proportionate share AND an estimate of that effect, if available
- The amount of pension expense recognized by the employer during reporting period
- Balances of pension related deferred inflows and outflows of resources categorized by source
- A schedule reflecting the next five years' aggregate deferred outflows and inflows that will be recognized in pension expense AND the employer's contributions subsequent to the measurement date

Employers with employees that participate in the Firefighters' and Rescue Squad Workers' Pension Fund will also need to disclose

- Information regarding the employer and nonemployer portions of the employer's share of the NPL
- The amount of special funding provided by nonemployer contributing entities

Required Supplementary Information (RSI)

There also will be new Required Supplementary Information which will be presented in a ten year schedule. It will not be necessary to present information retroactively; rather, the information will be presented as it becomes available over the next decade. RSI should include –

- Employer's proportionate share of the NPL in dollar amounts and percentage of total NPL
- Covered payroll
- Employer's proportionate share (in dollars) of NPL as a percentage of covered payroll
- Funded percentage of the plan

In addition to this, special funding situations will require –

- Statutorily or contractually required employer contributions
- Employer contributions recognized by the Plan
- Any difference between the above two components
- Employer's covered payroll
- Contributions recognized by the Plan as a percentage of the employer's covered payroll

Auditing Requirements

Much discussion has ensued about auditing the additional data and disclosures that will be required upon implementation of these statements. The AICPA has published two white papers and three audit interpretations, and will issue further guidance in 2015 via an update to the *State and Local Government Audit Guide.* Because the Plans will rely heavily on their actuaries for calculations, it is clear that Plan auditors will rely on the work of those experts in issuing their opinions. As a result, most of the auditing discussion has centered on auditing the census data that is supplied by the Plans to the actuaries to enable them to do their calculations. For North Carolina Plans, responsibility for accuracy of census data is shared by the Plans and the employer participants. It follows then that auditing the census data is a responsibility shared by the Plans auditors (OSA) and the auditors engaged by participant employers.

Some of this work is already being done at the employer level as part of the annual audit of payroll. Additionally, some of the work will need to be done by the employer participant auditor as part of the due diligence that must be done when relying on the work of the expert actuary. The end result of implementation will be a net pension asset or liability and pension expense being recorded on the employer participant financial statements. Because the auditors of those statements will be opinionating those statements, some work must be done for the auditors to gain comfort with the pension numbers and disclosures.

OSA also must gain comfort sufficient for them to issue their opinions not only on the State CAFR that reports the Plans' net position and disclosures, but also their separate reports on the proportionate share schedules that will be issued under a separate report. In this vein, using a risk based approach, OSA will each year choose a sample of participant employers for census data testing. This sample also will also perform census data testing for DST. This census data testing will be considered an attest engagement separate from the annual financial audit. Participant employers chosen for the Plans' June 30, 2014 fiscal year have been notified. Specific guidance for participant employers in the sample will be distributed each year. The sample will change each year, but the population in each plan is stratified, with larger employers being more likely to be picked more often, and very small employers not being picked at all. Those employers that fall in the middle should expect to be chosen for testing every 5 – 7 years.

Beginning in 2015, we anticipate notifying the chosen participant employers early in the calendar year so they may plan for this separate engagement and units can include the testing in their audit procurement processes.

It is important to note that the data being tested is done so on a calendar year basis to coincide with the valuation of the Plans. Units chosen for testing this year were tested on calendar year 2013 data because that is the data that was used to produce the December 31, 2013 valuation. You will recall that the calendar year valuation is rolled forward to the Plan's fiscal year end six months later (measurement date). In turn those numbers are used to determine each employer participants' proportionate share of the net pension asset or liability, and expense.

Data Elements Being Tested

OSA is requesting the following census data elements be tested at the employer participant level:

- Eligibility
- Compensation
- Date of birth
- Gender

DST is requesting the following census data elements be tested at the employer participant level:

- Class of employee
- Date the employee first reported as an employee of the participant employer
- Date of termination

As mentioned previously, many decisions regarding the implementation process have been made. The allocation percentages on which the participant employer's proportionate share is based will be determined by the Plan. OSA will attest to the system-wide net pension asset or liability, pension expense, and deferral amounts. Each participant employer's auditor should review and gain comfort with the State's numbers. Employer auditors also should be comfortable that the employers have adequate controls in place to ensure the accuracy of the data being submitted to each Plan. The Plan will provide each participant employer with its share of the net pension asset or liability, pension expense, and deferral amounts. Except for the items listed previously, the State's actuary will track the deferrals for each participant employer and that information will be provided to each participant employer annually.

Though the statements will implement many significant changes, it is just as important to understand what will **not** change. The statements do not address the **funding** of pension plans; the intent of the statements was to separate the accounting from the funding. The Plans will continue to obtain and act upon the annual valuations for funding recommendations as received from the State's actuary. The fiscal stability of the unit will not change based on this new guidance. The statements do not create any new pension obligations. Also, the accounting and reporting guidance for defined contribution plans will not change.

DST is planning on offering additional training to assist units, government officials, and auditors with statement implementation, including, among other things, webinars and regional training sessions. The sample financial statements will reflect these changes as well, effective with the June 30, 2015 fiscal year end. There is a webpage dedicated to GASB 67 and 68, https://www.nctreasurer.com/slg/lfm/audit_acct/Pages/Pension-Standards.aspx, which can provide additional guidance and other helpful resources. If you have any questions, please contact Sharon Edmundson, sharon.edmundson@nctreasurer.com or (919) 814-4289, or Preeta Nayak, preeta.nayak@nctreasurer.com or (919) 814-4291.