# Risk & Audit Committee

**California Public Employees' Retirement System**

## Agenda Item 6a

September 16, 2014

**ITEM NAME:** Governmental Accounting Standards Board (GASB) Statement No. 68 Audit Services

**PROGRAM:** Audit Services

**ITEM TYPE:** Information

**EXECUTIVE SUMMARY**

The purpose of this agenda item is to inform the Risk and Audit Committee that staff will request the CalPERS independent financial auditor, Macias Gini & O'Connell, LLP, to provide necessary audit services relating to GASB Statement No. 68. The services are within the scope of the existing contract.

**STRATEGIC PLAN**

This agenda item supports Goal B of the CalPERS 2012-17 Strategic Plan, cultivating a high-performing, risk-intelligent, and innovative organization, by delivering superior, end-to-end customer service that is adaptive to customer needs.

**BACKGROUND**

In June 2012, the Governmental Accounting Standards Board (GASB) issued two new standards that substantially changed the accounting and financial reporting of public employee pension plans and the state and local governments that participate in such plans. GASB Statement No. 67, *Financial Reporting for Pension Plans* revises existing guidance for the financial reports of most governmental pension plans. GASB Statement No. 68, *Accounting and Financial Reporting for Pensions* revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. GASB Statement No. 67 is applicable to CalPERS and effective for financial statements for fiscal years beginning after June 15, 2013. GASB Statement No. 68 is applicable to employers and effective for financial statements for fiscal years beginning after June 15, 2014.

<u>GASB Statement No. 68 Requirements</u>

GASB Statement No. 68 requires employers to recognize a liability as employees earn their pension benefits (that is, as they provide services to the government). To the extent that a long-term obligation to provide pension benefits (that is, total pension liability) is larger than the value of the assets available in the plan (that is, fiduciary net position) to pay pension benefits, the employers must report a net pension liability on the employer's accrual-based financial statements for the first time.

Challenges of Employers in Cost-Sharing Multiple-Employer Plans and their Auditors

A cost-sharing multiple-employer plan (cost-sharing plan) is one in which the participating employers pool their assets and their obligations to provide defined pension benefits, such as school employers and employers participating in risk pools. GASB Statement No. 68 requires employers in cost-sharing plans to recognize their proportionate share of the collective pension amounts for all benefits provided through the plan. To the extent that a long-term obligation to provide pension benefits is larger than the value of the assets available in the plan to pay pension benefits, there is a collective net pension liability for which each employer must report its proportionate share in their financial statements. To comply with GASB Statement No. 68, cost-sharing plan employers will need information beyond what is provided in the plan's financial statements as presented in accordance with GASB Statement No. 67. Similarly, employer auditors face challenges in terms of obtaining sufficient appropriate evidence in order to opine on the pension amounts included in the employers' financial statements.

Challenges of Employers in Agent Multiple-Employer Plans and their Auditors

An agent multiple-employer plan (agent plan) is one in which the assets of the employers are pooled for investment purposes but separate accounts are maintained for each individual employer. To comply with GASB Statement No. 68, agent plan employers will also need information beyond what is provided in the plan's financial statements. GASB Statement No. 67 does not require the plan administrator to report specific pension amounts, actuarial information, and fiduciary net position for each individual employer. The employers do not have direct access to the underlying plan's records and data supporting such amounts. Similarly, employer auditors face challenges in terms of obtaining sufficient appropriate audit evidence regarding the specific pension amounts included in employers' financial statements.

CalPERS Plan to Provide Pension Liability Information to Employers

In anticipation of employers' need, in March 2013 Finance and Administration Committee approved the Actuarial Office's recommendation to provide employers, on a voluntary fee for service basis, the actuarial information necessary for their accounting and financial reports as required under GASB Statement No. 68.

American Institute of Certified Public Accountant (AICPA) Recommendations

To help resolve the challenges faced by cost-sharing plan employers and their auditors, AICPA State and Local Government Expert Panel (SLGEP) issued a whitepaper in February 2014 proposing the following solutions:

- The plan prepares a schedule of employer allocations and related notes to the schedule, displaying the proportionate relationship of each employer to all employers and each employer's allocation percentage (Attachment 1).
- The plan prepares a schedule of pension amounts by employer and related notes to the schedule (Attachment 2) or a schedule of collective pension amounts (Attachment 3). The schedule of pension amounts by employers provides all the

elements each employer needs to prepare its financial statements, including the net pension liability, the various categories of deferred outflow of resources and deferred inflows of resources, and pension expense for all participating employers. The schedule of collective pension amounts reports only collective pension amounts and does not include changes in proportion between periods and differences between actual contributions made by an employer and their proportionate share of total contributions calculated based on the allocation percentage.

- The plan engages its auditor to obtain reasonable assurance and report on the schedule of employer allocations, related notes to the schedule, the total net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense.

To help resolve the challenges faced by agent plan employers and their auditors, AICPA's SLGEP issued a whitepaper in May 2014 proposing the following solutions:

- The plan actuary issues a separate report specific to each employer, which includes an actuarial certification letter addressed to employer management.
- The plan prepares a schedule of changes in fiduciary net position by employer and related notes to the schedule (Attachment 4).
- The plan engages its auditors to issue the following reports:

| | Option 1 | Option 2 |
|---|---|---|
| Census Data Maintained by the Plan | A service organization controls 1 (SOC 1) Type 2 report on controls over census data | An examination engagement over selected management's assertions related to census data |
| Schedule of Changes in Fiduciary Net Position | Opine on the schedule as a whole and issue a SOC 1 Type 2 report on the controls over the calculation and allocation of additions and deductions to employer accounts | Opine on both the schedule as a whole and on each employer column in the schedule |

Actuarially derived pension liabilities are dependent on demographic data of the plan participants, which is referred to as census data. Significant elements of census data may include: date of birth; date of hire or years of services; marital status; eligible compensation; class of employee; gender; date of termination or retirement; spouse date of birth; and employment status (active, inactive, or retired). The plan is acting as a service organization with regard to the census data maintained by the plan. If option 1 is selected, CalPERS management will describe the CalPERS system of controls, including policies and procedures designed and implemented to ensure the completeness and accuracy of retired and inactive member census data and proper accumulated of active member census data reported to the CalPERS. A SOC 1 Type 2 report provides descriptions of the controls in place and an independent opinion on whether the controls were suitably designed and operating effectively. If option 2 is selected, CalPERS management will make specific assertions addressing the completeness and accuracy of census data. The auditor will opine on whether management assertions are fairly stated.

In order to properly account for each employer's specific interest in the agent plan's fiduciary net position, the plan has to calculate and allocate additions and deductions for each employer's separate account. In this regard, the plan is acting as a service organization. If option 1 is selected, the plan auditor will obtain reasonable assurance and report on the schedule of changes in fiduciary net position by employer as a whole, and related notes to the schedule. Because such an opinion alone would not provide assurance at a level needed for each individual employer and would not provide sufficient evidence on the allocation of additions and deductions to each employer, the plan auditor will issue a SOC 1 Type 2 report on the controls over the calculation and allocation of additions and deductions to employer accounts. The SOC 1 Type 2 report would give employers evidence that controls over the plan's calculation and allocation of the contributions, net investment income, benefit payments, refunds, and administrative expenses to employer accounts are suitably designed and operating effectively. If option 2 is selected, the plan will engage an auditor to obtain reasonable assurance and report on both the schedule as a whole and on each employer column in the schedule of changes in fiduciary net position by employer and related notes to the schedule.

**ANALYSIS**

In anticipation of future demand for sufficient appropriate audit evidence supporting the employers' pension amounts, we examined the following alternatives:

- Alternative 1 - Do not engage auditors to perform audits.
- Alternative 2 - Assign internal audit staff to perform the audits.
- Alternative 3 - Engage the financial auditor to provide audit coverage.
- Alternative 4 - Hire another external firm to perform the audits.

Alternative 1: We did not select alternative 1 because it is unlikely that employer auditors will be able to accumulate sufficient appropriate audit evidence necessary to issue unmodified opinions on the financial statements of employers participating in cost-sharing plans with material pension amounts. Unaudited information provided by CalPERS to the employers to support their pension amounts would not be sufficient appropriate audit evidence for their auditors to base their opinions. While additional work may be performed by employers and their auditors to adequately verify unaudited information provided by CalPERS, those employers and their auditors have no direct access to key data of other employers participating in the cost-sharing plans that supports the employer's proportion of the collective pension amounts.

Individual audit firms would have to approach CalPERS to obtain necessary information, causing significant workload and inefficiencies.

Alternative 2: We did not select alternative 2 because Office of Audit Services (OFAS) is not set up to perform attestation engagements under AICPA standards. Also, Government Code Section 13886.5(a) requires state agencies to conduct internal audit activity in accordance with the *International Standards for the Professional Practice of Internal Auditing* (Standards) prescribed by the Institute of Internal Auditors. The Standards require internal auditors to possess the knowledge and skills needed to perform their individual responsibilities. The Standards also require the Chief Auditor to obtain competent advice and assistance if the internal auditors lack the knowledge and skills needed to perform all or part of the engagement. Currently, OFAS does not have staff with pension actuarial valuation experience. Therefore, alternative 2 will cause non-compliance with the Government Code Section 13886.5(a) and the Standards.

Alternative 3: We selected alternative 3 engaging the CalPERS independent financial auditor, Macias Gini & O’Connell LLP, to provide the audit services. This alternative enables CalPERS to provide the audit coverage needed by employers and their auditors, provides employers with the level of independence expected, and complies with the Government Code Section 13886.5(a) and the Standards. Also, existing contract with Macias Gini & O’Connell LLP includes attest services other than financial audits, which allows GASB Statement No. 68 audit services to be commenced more timely in order to meet the demands of employers and their auditors. In addition, this alternative is potentially more cost effective for employers in that CalPERS independent financial auditors would have obtained an understanding of the CalPERS business and system of internal controls as part of their financial audit.

Alternative 4: We did not select alternative 4 because the time needed to prepare a Request for Proposal (RFP) and select an external firm may delay the audits beyond the point in time when employers need the reports. It was not possible to initiate a RFP earlier because the AICPA did not publish the auditing guidance related to agent plan until May 2014 and did not issue the authoritative auditing interpretations until June 2014. The practical application of the auditing guidance is still being determined by practitioners.

**BUDGET AND FISCAL IMPACTS**

Audit service costs associated with GASB Statement No. 68 are to be paid by employers who use the services. While the expenses may initially be paid out of the Public Employees’ Retirement Fund (PERF), they are to be subsequently reimbursed through collection of fees from the employers. CalPERS staff is in the process of finalizing the details of the fee structure.

**BENEFITS/RISKS**

Benefits of Alternative 3 include the following:

- Provide better customer services to employers by assisting them with meeting their audit needs.
- Reduce workload impacts to CalPERS operations.
- Ensure compliance with the Government Code Section 13886.5(a) and Standards.

Risks of Alternative 3 include the following:

- Audit service costs are to be paid by employers who use the services. The number of employers requesting for information is unknown at this time. Costs per employer may be higher than the amounts employers would like to pay.

**ATTACHMENTS**

Attachment 1 – Example Schedule of Employer Allocations
Attachment 2 – Example Schedule of Pension Amounts by Employer
Attachment 3 – Example Schedule of Collective Pension Amounts
Attachment 4 – Example Schedule of Changes in Fiduciary Net Position by Employer

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