Kicking the Tires Without Stubbing Your Toe – Pension Plan Due Diligence and Audit Procedures for Employers

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WHY EMPLOYER DUE DILIGENCE?

- TMRS will often represent the single largest financial asset and the single largest liability your city has.
- Public, media, and investor scrutiny demand that we speak knowledgeably regarding our pension commitments.
- Auditors will expect us to sign representations acknowledging our responsibility and attesting to the fair statement of the number.
START THE JOURNEY...

- Employers shouldn’t allow themselves to be intimidated by the complexity and size of pensions
  - Get educated
  - Set goals for the program, including interim steps
  - Recognize all the resources available to help
  - Remember plagiarism is enthusiastically encouraged
  - Know that the program will grow and evolve and does not need to be perfect
GOALS FOR DUE DILIGENCE

- **Adequate Funding of the Plan**
  + View TMRS’ actuarially defined employer contribution (ADEC) as a minimum, not a maximum
  + Develop strategies that fit the organization

- **Full and Fair Reporting of All Pension Numbers**
  + In compliance with GAAP
  + Full and adequate disclosure
  + Understandable to the intended audience
BASIC ELEMENTS OF DUE DILIGENCE

**Monitoring**
- Nothing more than familiarity with TMRS in general and your plan in particular

**Internal Controls**
- Quality of controls over onboarding and payroll, and have they been documented to show how they support the numbers in the TMRS reports?

**Kicking the Tires**
- Actually reading what you are sent, tying a few numbers and asking yourself, “Does this make sense?”

**Explaining the Numbers**
- Know your stuff, Know your audience, including existing perceptions, keep it simple, and find common points of comparison
MONITORING

- Much of what you will need is available on the TMRS website
  - Home Page
    - Announcements of key events
    - Links to meeting minutes
    - Links to funding valuation and annual report
  - Eye on GASB
    - Employer Reporting Package
    - Employer Reporting Guide
    - Actuarial Information — funding policy and experience studies
    - Investment information supporting rate of return
MONITORING

+ Individual City Portal
  - SOC 1 Type 2 Audit Report
  - Census Data
Know Your Plan

- Why did funding status improve or deteriorate?
- What assumptions are producing the most actuarial gains or losses over time?
- Are the demographics of my plan participants changing?
- Is my prior service rate on my funding contribution covering accrued interest on the unfunded liability?
INTERNAL CONTROLS

- Eligibility — controls to ensure that employees working more than 1,000 hours per year are enrolled
- Onboarding — initial enrollment and record keeping
- Ongoing controls supporting the TMRS-3 Form (Summary of Monthly Payroll Report)
INTERNAL CONTROLS

- TMRS has furnished all employers with a list of controls as well as the SOC-1 report
  - The closer the documentation of your controls uses the same terms and structure as TMRS, the easier to demonstrate the integrity of the baton pass between entities and the integrity of the census data
- Process for following up on errors on TMRS-3
  - It is critical that your contributions tie to TMRS
KICKING THE TIRES

- Read the actuarial certification letter looking for key elements including:
  - Addressed to your city
  - Prepared in compliance with GASB 68 and actuarial standards of practice
  - Signed by actuaries with the appropriate qualifications

- Download from the TMRS City Portal and read the SOC 1 Type 2 audit report issued by KPMG. Assurance whether internal controls were in place:
  - Additions and deductions to your city’s Benefit Accumulation Fund (BAF)
  - Census data that is derived from your city’s reports that are sent to TMRS

- Read the audit opinion related to the Statements of Changes in Fiduciary Net Position by City. Find your city’s row and:
  - Tie additions to your city’s contributions during the year
  - Review investment earnings for reasonableness
  - Tie the ending balance to the Fiduciary Net Position used to calculate your city’s Net Pension Liability (NPL)
KICKING THE TIRES

- Download the census data used for your city’s valuation from the TMRS City Portal and review for reasonableness and completeness.
- Review the calculation of pension expense, the schedule of deferred inflows and outflows, and the NPL itself provided in the GASB 68 reporting package for reasonableness.
- Use GASB 68 paragraphs 37-47 as your disclosure checklist to ensure that all required notes and RSI have been included.
EXPLAINING THE NUMBERS

- Fundamental Truth:
  + Explaining good numbers is always easier than explaining bad numbers
- Funding Valuation
  - No difference with GASB 68 on liability side, except for cities with ad hoc benefits considered “substantively automatic”
  - Smoothed investments vs. market value FNP
  - ADEC will not take effect until 12 months and a day after valuation
  - Strategies for improving funding status and reducing impact of future rate increases
EXPLAINING THE NUMBERS

- **GASB 68 Valuation** (Carrollton results—yours may vary)
  
  + Funded status is higher for GASB 68 because market value FNP is higher than the smoothed portfolio value for funding but both valuations are as of 12/31/2014
  
  + Funded status improved. EOY NPL of $7,349,000 during the year by $912,000
  
  + Funded status is 97.94% but TPL is $356,703,000 & FNP is $349,354,000
  
  + Deferred outflow (loss) on Investment return
  
  + Deferred Inflow (gain) on liability assumptions (inflation incl.-COLAs & pay raises, mortality, turnover etc.)
EXPLAINING THE NUMBERS

- Sensitivity Analysis

*Table: Sensitivity of the Net Pension Liability to Changes in the Discount Rate*

<table>
<thead>
<tr>
<th>1% Decrease 6.00%</th>
<th>Current Single Rate Assumption 7.00%</th>
<th>1% Increase 8.00%</th>
</tr>
</thead>
<tbody>
<tr>
<td>$58,242,343</td>
<td>$7,348,955</td>
<td>$(34,406,049)</td>
</tr>
</tbody>
</table>

- Shows the significance of investment return
- Shows that sensitivity is a function of the size of the two components TPL and FNP not the net (NPL)

- TMRS, in a periodic review of assumptions, lowered the expected return to 6.75% in July 2015
  - Could impact funded status next year and required contributions in 2017
  - We will disclose this decision in our current FS
KEYS FOR SUCCESS

- One or two individuals should be responsible for the program
- Those individuals should have
  + A clear mandate
  + Adequate time
  + Adequate resources
  + Adequate training
- Periodic top management follow-up
FINAL THOUGHTS

- TMRS has done a tremendous job laying the groundwork for a successful implementation.
- However, they cannot finish the job and they are now passing the baton to you and your auditor.
- Employer Due Diligence recognizes that pensions are often your largest financial asset and liability and demonstrates that you have fulfilled your responsibilities for it.
Auditor Considerations for GASB 68

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1. User controls noted in the TMRS SOC 1 report

2. Census data from the employer side

3. Accounting Actuarial Valuation Report

4. Schedule of Changes in Fiduciary Net Position
Complementary User Entity Controls

Auditor must determine if the complementary user controls identified in the SOC 1 audit report were appropriately designed and operating effectively throughout the employer’s fiscal year.

Possible auditor procedures:

1. Gain an understand of the employer process to address each control.

2. Sample/examine evidence of design and operating effectiveness.
Complementary User Entity Controls – Example Controls

Controls should be established to ensure municipal representatives (city correspondents) are authorized to create TMRS-16 forms for new member enrollment data.

- Employer control is only certain individuals may approve/sign the TMRS-16 forms.
- Look at a sample of TMRS-16 forms for appropriate authorization as compared to an authorized signor listing.
Controls should be established to ensure payroll amounts included in the TMRS-3 forms submitted to TMRS are complete and accurate.

- Control is a designated individual will reconcile the TMRS-3 form to the underlying detail payroll report prior to signing and submitting. Also employer compares to prior pay period for reasonableness.

- Select a sample of TMRS-3 forms submitted and compare the payroll amounts back to employer supporting documentation while verifying the approver was authorized. Inquire/walk through the process performed to compare to prior pay period for reasonableness.
Complementary User Entity Controls – Example Controls

Controls should be established to ensure access to PCs/terminals (containing payroll and TMRS-related information) is limited to authorized and appropriate individuals.

- Control is a quarterly review of the individuals with access to determine if access to necessary and appropriate.
- Select a sample of the documented reviews and walk through with the business owner how they determine necessary and appropriate access and how changes are made.
Census Data

Auditor considerations include the completeness and accuracy of the census data.

Possible auditor procedures:

1. Obtain the census data file sent to the actuary.

2. If obtained from the plan, might need to consider a confirmation from the actuary.

3. Obtain and review a reconciliation of the aggregate census data to the valuation report.

4. Obtain a roll forward of census data and review the employer reconciliation for reasonableness.
Census Data

Possible auditor procedures for active members:

1. Select a sample of new active members from the census file and verify member was eligible to participate AND agree participant information from the census file to source documents in the employer personnel files.

2. Select a sample of active members from the census file and validate the accuracy of the data including covered payroll.

3. Select a sample of employees from the employer payroll system and determine if enrolled in the plan and properly included/excluded from the census file. (completeness)
1. TMRS’ actuary has issued one for each employer.

2. Content of an actuarial report would generally include:

   - Actuarial certification letter,
   - Total pension liability as of the valuation date,
   - Sensitivity analysis of net pension liability,
   - Discount rate calculations,
   - Summary of actuarial methods and assumptions, and
   - Schedules of pension components and deferred outflows/inflows.
Possible auditor procedures:

1. Discussion with management regarding:
   a. Employer process to review the actuary report for content.
   b. How did employer assess the qualifications of the actuary?
   c. Process for reviewing calculations for pension expense and deferred inflows/outflows for reasonableness.
   d. Evaluation of the assumptions for reasonableness.

2. Evaluate the competence, capabilities, and objectivity of the actuary.
Schedule of Changes in Fiduciary Net Position (Schedule)

Employer is responsible for establishing a financial reporting process for measuring its net pension liability.

Possible auditor procedures:

1. Confirm the employer has reconciled the Schedule to the employer and member contributions for accuracy.

2. Work with employer management to determine the reasonableness of benefit payments possibly based on prior year payments, number of retirees, etc.
What Additional Questions Do You Have?