October 6, 2016

MEMORANDUM

To: CPA Firms Who Audit Local Governments With Pension Plans

From: Jerry E. Durham, CPA, CGFM, CFE 

Assistant Director

Division of Local Government Audit

Subject: Government Fiduciary Responsibilities

CPA Colleagues,

I have received several requests to clarify the Division of Local Government Audit’s (Division) position on fiduciary responsibility. GASB issued an Exposure Draft on December 8, 2015 entitled *Fiduciary Activities*. This document along with GASBS 68, has opened up an issue that was first raised in NCGAS 1, then GASBS 14, GASB 32, and again in GASBS 34.

I first raised this issue on behalf of the Division in the Pension Memo that was sent out on December 16, 2014 referring specifically to Pension Plans. My comment, referring to the Exposure Draft at that time was, “While this document is not GAAP yet, it does give CPAs more guidance than is currently available anywhere else.”

According to the *Fiduciary Activities* Exposure Draft, “…existing standards do not provide guidance regarding characteristics that should be considered in deciding whether a government has a fiduciary responsibility” and “…which fiduciary activities should be reported by governments has been interpreted differently, resulting in a lack of comparability between governments.”

Based on my discussions with GASB, the Exposure Draft merely interprets what we should have been doing all along.

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**457 Plans and Other Deferred Compensation Plans**

The question is, when should fiduciary activity be reported as part of a government’s financial statements? For example, based on GASBS 32 guidance, most 457 Plan assets have not been reported as part of the government’s fiduciary assets. This was a correct interpretation of GASBS 32 **unless** the government still maintained control of the 457 Plan assets. By control I mean, either the government maintained administrative control of plan assets (such as making investment decisions for the plan) or physically controlled or possessed the assets of the plan. Because of IRS Regulations, 457 Plans established before 1996 should include clauses that call for the government to maintain legal rights to plan assets. In those situations, 457 Plan assets should have been presented as part of the government in a fiduciary fund. This also means these 457 Plans should have been audited since they should have been included in the government’s financial statements. Even after the issuance of GASBS 32, governments were still required to determine the level of administrative involvement they had with the Plan so as to determine whether Plan Assets should be reported in a fiduciary fund of the government. GASBS 32, Paragraph 19 of the Basis for Conclusions states, “Section 457 plans that meet the criteria for inclusion in the fiduciary funds of a government should be reported as trust funds.” It is clear that the intention of GASBS 32 was **not** to **exclude all** 457 Plans from being reported as fiduciary funds of the government.

The concept of control under GASBS 32 has been variously understood and applied and the Division has not taken exception to the various interpretations. However, in light of the definition of control in the new *Fiduciary Activities* Exposure Draft, it would be prudent for CPA firms to take a second look at each 457 Plan agreement examining clauses that unequivocally indicate control (i.e. fiduciary responsibility). This would ensure each government is reporting its Plan in accordance with applicable accounting standards. The same could be said for other types of Deferred Compensation Plans as well.

GASBS 14, paragraph 19, states “…there may be organizations that do not meet the definition for inclusion in the financial reporting entity. They should nevertheless, be reported as a fiduciary fund of the primary government if the primary government has a fiduciary responsibility for them.” This simply means that, even if the entity does not meet the definition for inclusion as a component unit, the entity should be included in the primary government’s financial statements **if** the primary government has a fiduciary responsibility for the entity. Again, this would mean the entity for which the primary government has a fiduciary responsibility should be audited since it would be included in the government’s financial statements. GASB’s Implementation Guide 2015-1, Question 4.14.1 further explains paragraph 19.

GASB’s *Fiduciary Activities* Exposure Draft provides a clear definition of fiduciary responsibility. The GASB Standard is expected to be issued by the 4th Quarter 2016, but the proposed effective date for the GASB Standard is for reporting periods beginning after December 15, 2017. Earlier application is encouraged.

So what do we do in the meantime?

GASB admits there has been confusion and a lack of clear guidance about the definition of control (i.e. fiduciary responsibility). I think GASB’s assessment is correct. The Division of Local Government Audit proposes the following solution:

1. The Division encourages reporting 457 Plans and other types of Deferred Compensation Plans as fiduciary funds of the government when there is sufficient appropriate evidence demonstrating a government has administrative and/or physical control over plans assets. We recommend using the *Fiduciary Activities* Exposure Draft to assist in making those decisions.
2. The Division also encourages CPAs to advise local governments as to the requirements of the new Exposure Draft in preparation for any changes that may be necessary (i.e. possibility of an audit and additional costs).
3. Any 457 or other type of Deferred Compensation Plan over which the government has fiduciary responsibility **should be audited**.
4. The new Exposure Draft makes it clear that stand-alone financial statements of business-type activities should include resources over which the business-type activity has a fiduciary responsibility.
5. CPA Firms should obtain and read plan agreements and document those agreements in their working papers. In some cases the plan agreements will be quite old. The older the agreement, the more likely there will be some measure of administrative and/or physical control.
6. Nothing in 1-5 above is intended to prevent separate reporting for a Government and its 457 Pension Plan or Other Deferred Compensation Plans (i.e. Trust Funds).  However, if a report does not include all required funds, the Independent Auditor’s Report would need to address the departure from GAAP (e.g., qualified opinion if necessary).
7. 457 Plans or Deferred Compensation Plans would **not** be included as fiduciary funds of the government when there is sufficient appropriate evidence demonstrating a government has relinquished administrative and physical control over plan assets to a third party administrator or trustee. We recommend using the *Fiduciary Activities* Exposure Draft to assist in making those decisions.

**Proposed Solution – 457 Plans and Other Deferred Compensation Plans:**

**The Division believes current standards support the reporting of a fiduciary fund in the situations discussed above and we may question an entity’s financial statement presentation and a CPA’s audit response in certain obvious situations.  However, the Division will continue to allow discretion when making determinations about fiduciary responsibility and financial statement presentation as it relates to 457 Plans and Deferred Compensation Plans until the effective date of the Exposure Draft.  Our office will not require financial statements to be restated and resubmitted until the *Fiduciary Activities* Exposure Draft is finalized into an Accounting Standard and that Standard becomes effective.**

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**Pension and OPEB Trust Funds**

Many of the same principles noted above apply to Pension and OPEB Trust Funds (defined benefit and defined contribution). The applicable current general guidance is found under NCGAS 1, paragraph 1 and GASBS 34. The new *Fiduciary Activities* Exposure Draft specifically addresses Pension Trusts and OPEB Trusts.

There are four possible situations involving Pension and OPEB Trusts CPAs are likely to encounter:

1. **Governments administer and/or control the Trust and present the Trust as a fund of the government.**
   1. This fund must be audited.
   2. In some cases a formal Trust Agreement may not exist.
2. **The government deposits Trust Fund assets with a third party administrator or trustee and evidence of administrative and/or physical control exists:**
3. The Division encourages reporting Pension and OPEB Plan Trusts as fiduciary funds of the government when there is sufficient appropriate evidence demonstrating a government has administrative and/or physical control over plans assets. We recommend using the *Fiduciary Activities* Exposure Draft to assist in making those decisions.
4. The Division also encourages CPAs to advise local governments as to the requirements of the new Exposure Draft in preparation for any changes that may be necessary (i.e. possibility of an audit and additional costs).
5. Any Pension or OPEB Trust over which the government has a fiduciary responsibility **should be audited**.
6. The new Exposure Draft makes it clear that stand-alone financial statements of business-type activities should include resources over which the business-type activity has a fiduciary responsibility.
7. CPA Firms should obtain and read plan agreements and document those agreements in their working papers. In some cases the plan agreements will be quite old. The older the agreement, the more likely there will be some measure of administrative and/or physical control.
8. Nothing in a-e above is intended to prevent separate reporting for a Government and its Pension Plan (i.e. Trust Fund). However, if a report does not include all required funds, the Independent Auditor’s Report would need to address the departure from GAAP (e.g., qualified opinion if necessary).
9. **Audits are performed for a fund (e.g. a utility fund) of a government, but financial statements are separately issued for the (utility) fund.**
   1. The *Fiduciary Activities* Exposure Draft does not address a situation where stand-alone financial statements are issued for a fund of the government according to GASB staff.
   2. GASB has not established GAAP for reporting of stand-alone financial statements for individual government funds whether governmental or proprietary fund types. The AICPA *State and Local Governments Audit and Accounting Guide* (SLAAG) provides guidance to auditors who present stand-alone financial statements for an individual fund of a government (Paragraphs 15.87 through 15.90). The footnote to paragraph 15.87 states that GASB did not clear this guidance.
   3. The import of the guidance in the SLAAG is that practitioners should apply all relevant GAAP when presenting stand-alone fund financial statements.
   4. It is the Division’s judgment that relevant GAAP would require including all resources over which the government has a fiduciary responsibility. The most obvious example would be that of a utility fund of a local government that has a private pension plan, is separately audited, and issues stand-alone fund financial statements.
   5. Assume the following facts: A local government operates a utility as a fund of the government. The utility fund is separately audited and stand-alone financial statements are issued for the utility fund. The utility has a private pension plan (i.e. Trust) that is directly associated with the operations of the utility and over which the governing body (e.g. city council), management, or a separate board of directors has administrative and/or physical control of the Plan’s assets. The Plan Trust should be reported as part of the financial statements of the utility when stand-alone fund financial statements are published since this is GAAP for business-type activities according to the new *Fiduciary Activities* Exposure Draft. Based on the SLAAG guidance above, this would become relevant GAAP for stand-alone business-type fund financial statements.
   6. CPA Firms should obtain and read plan agreements and document those agreements in their working papers. In some cases the plan agreements will be quite old. The older the agreement, the more likely there will be some measure of administrative and/or physical control.
   7. Nothing in a-f above is intended to prevent separate reporting for a Government and its Pension Plan (i.e. Trust Fund). However, if a report does not include all required funds, the Independent Auditor’s Report would need to address the departure from GAAP (e.g., qualified opinion if necessary).
10. **The government deposits Trust Fund assets with a third party administrator or trustee and the government does not have administrative and physical control:**
    1. Pension and OPEB Plan Trusts would not be included as fiduciary funds of the government when there is sufficient appropriate evidence demonstrating a government has relinquished administrative and physical control over plan assets to a third party administrator or trustee. We recommend using the *Fiduciary Activities* Exposure Draft to assist in making those decisions.

**Proposed Solution – Pension and OPEB Trust Funds:**

**The Division believes current standards support the reporting of a fiduciary fund in the situations discussed above and we may question an entity’s financial statement presentation and a CPA’s audit response in certain obvious situations.  However, the Division will continue to allow discretion when making determinations about fiduciary responsibility and financial statement presentation as it relates to Pension and OPEB Trust Funds until the effective date of the Exposure Draft.  Our office will not require financial statements to be restated and resubmitted until the *Fiduciary Activities* Exposure Draft is finalized into an Accounting Standard and that Standard becomes effective.**

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While these proposed solutions are not entirely satisfactory from the viewpoint of the Division of Local Government Audit, we believe they are a reasonable approach given the admission by GASB that currently there is a lack of guidance on exactly what constitutes “fiduciary responsibility”. In addition, we recognize that for certain governments this may entail significant planning and cost.

The Division realizes that some governments and their CPA Firms are already applying the concept of fiduciary responsibility when reporting 457 Plans, Deferred Compensation Plans, and Trust Funds and these Plans are currently audited. The Division of Local Government Audit appreciates their diligence in applying current accounting guidance. As noted above, in our judgment, the new Exposure Draft merely interprets what current standards have required all along.

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Thanks to each CPA Firm for your continuing cooperation as we deal with these difficult issues related to pensions. Please share this memo with other members of your staff that are involved in auditing entities that have pensions.

Feel free to contact us if you have questions about this memo. The best way to contact us is by telephone. Our contact information is as follows:

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