GASB STATEMENT NO. 45
OTHER (THAN PENSIONS) POSTEMPLOYMENT BENEFITS

Plan Sponsor Reporting and Disclosure

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GASB: OTHER (THAN PENSIONS) POSTEMPLOYMENT BENEFITS
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On June 21, 2004, the Governmental Accounting Standards Board approved Statement No. 45 (GASB 45), accounting standards for *other* (than pensions) *postemployment benefits* (OPEB). Accounting for these benefits – primarily postretirement medical – can have significant impact on state and local government financial statements. This article summarizes GASB 45 including the basics, some idea of the magnitude, and action steps you should be taking now. (GASB's Statement No. 43, which sets uniform financial reporting standards for OPEB *plans*, is not discussed in this article.)

BACKGROUND

Historically, most public sector entities have accounted for OPEB using a "pay-as-you-go" approach; very few have prefunded or even accrued for these benefits. This means OPEB costs are ignored while an employee renders service and recognized only after an employee retires. GASB argues this delayed recognition shifts "costs" from one taxpaying generation to another. The GASB position is that OPEB, like pension benefits, are a form of deferred compensation. Accordingly, GASB 45 requires recognizing OPEB (in the financial statement) *as employees render service* (and consequently earn the benefit), rather than when paid.

EFFECTIVE DATES

GASB 45 effective dates are phased in similar to GASB's Statement No. 34:

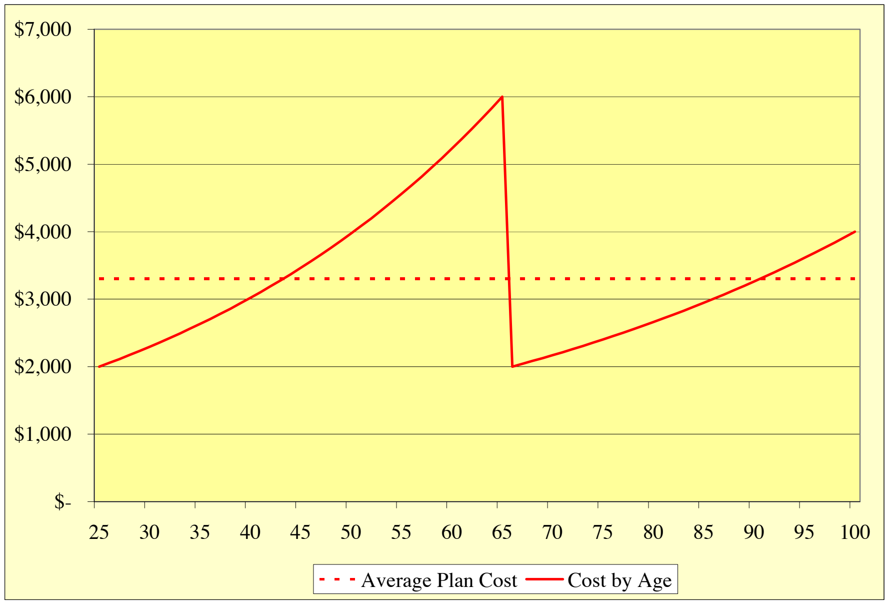
- Fiscal years beginning after December 15, 2006 for GASB 34 phase 1 governments (total annual revenue of $100 million or more)
- Fiscal years beginning after December 15, 2007 for GASB 34 phase 2 governments (total annual revenue of $10 million to $100 million)
- Fiscal years beginning after December 15, 2008 for GASB 34 phase 3 governments (total annual revenue less than $10 million).

While these dates seem far away, planning for transition to the new standards will take time. Many agencies will want to understand the implications on their financial statements and bond ratings well in advance of required implementation dates.

WHAT BENEFITS ARE OPEB?

OPEB includes most postemployment benefits, other than pensions, that employees are entitled to after leaving employment: retiree medical, dental, prescription drug, vision, life insurance, group legal, and long-term care benefits. OPEB also includes disability benefits when not provided in a pension plan. They do not include vacation, sick leave, COBRA, or ad hoc early retirement incentives, which fall under other GASB accounting statements. Here are a few OPEB examples:

- Agency pays a retiree's healthcare premium after retirement if an employee works for the agency at least 10 years and retires directly from the agency.
- City allows retirees to continue participating in the medical plan after retirement, but charges some retirees the plan's average per-capita cost (and others less), which is below the retiree's full cost. The following chart illustrates how a plan's medical costs might vary by age:



In this example, retirees charged the average ($3,300) plan cost are getting a benefit worth substantially more than they're paying. This difference is referred to as the "implied subsidy."

- District participates in PEMHCA (CalPERS Healthcare Program), using a cafeteria plan to pay active employee premiums. The district, as generally required under PEMHCA law, pays the $48.40 minimum toward retiree's 2005 PEMHCA premiums. (The $48.40 minimum increases over the next few years to $97 in 2008.)

Action Steps

➔ Examine your agency's benefits to identify OPEB and your degree of compliance concerns.

➔ Summarize your agency's benefit promise (by gathering information from MOUs, council or board resolutions, etc.) to greatly facilitate the valuation and implementation process.

ACCOUNTING STANDARDS

Under GASB 45, pay-as-you-go accounting is replaced with accrual accounting. This is virtually identical to GASB's approach under Statement No. 27, with the key financial statement components being an Annual Required Contribution, an Annual OPEB Cost, and a Net OPEB Obligation. (Before we describe these 3 terms you might want to refer to the Actuarial Definitions on page 9.)

- **Annual Required Contribution (ARC)**: GASB 45 doesn't require an agency to make up any shortfall (unfunded Actuarial Liability) immediately, nor does it allow an immediate credit for any excess Plan Assets. Instead, the difference is amortized over time. An agency's ARC is nothing more complicated than the employer current Normal Cost (value of benefits being "earned" during a year), plus the amortized unfunded Actuarial Liability (or less the amortized excess Plan Assets). Simply put, ARC is the value of benefits earned during the year plus (or minus) something to move the plan toward being on track for funding.

GASB 45 allows actuaries to amortize the unfunded Actuarial Liability (or excess Plan Assets) on a level dollar or level percent of payroll basis. We believe most agencies will want to use a level percent of payroll amortization because it's more consistent with the budget process and how pension contributions are usually calculated. ARC must be based on the underlying OPEB promise (as understood by the plan sponsor and employees).

- **Annual OPEB Cost (AOC)**: The first year an agency complies with the new standards, the AOC equals the ARC. In subsequent years, the AOC will equal the ARC, adjusted for prior differences between the ARC and AOC.
- **Net OPEB Obligation (NOO)**: An agency's NOO is the historical difference between actual contributions made and the ARC. If an agency has always contributed the ARC, the NOO equals zero. However, an agency has not "made" the contribution unless it has been set aside *and* cannot legally be used for any other purpose.

Implementation Process

The implementation process will be relatively straightforward: An agency will hire an actuary to calculate the ARC. The first time an agency does this, their AOC equals their ARC. The agency then decides whether to contribute all, none, or part of the ARC into a Trust that cannot legally be used for any purpose other than paying OPEB.

If an agency always contributes the ARC, then each subsequent year's AOC equals their ARC – and the NOO is zero. The first year an agency does *not* contribute the ARC, they must establish an NOO equal to the difference between their actual contribution and the ARC. The subsequent year's AOC equals the ARC, adjusted for interest and amortization of the NOO.

Action Step

➔ Gather participant data (your actuary should be able to tell you what you'll need once they review your underlying benefit promise).

GASB 45 REQUIREMENTS

Disclosure Requirements

This may be the most important aspect of GASB 45. When disclosed, some agencies will show large OPEB unfunded liabilities, while others will show small or no unfunded liabilities. These differences *may* require an adjustment in an agency's bond rating. Plan sponsors must disclose in their financial statement footnotes:

- Basic plan information:
  - Plan type
  - Benefits provided
  - Authority under which benefits were established
- Plan funding/contribution policy information:
  - Required contribution rates for active members and employers shown in dollars or as a percent of payroll
- Plan Funded Status information:
  - AOC and the dollar contributions actually made
  - If the employer has a NOO, also
    - Components of the AOC
    - NOO increase or decrease during the year
    - End of year NOO
  - 3-year history of
    - AOC

    - Percent of AOC contributed during the year
    - End of year NOO
- Most recent year's plan Funded Status
- Actuarial methods and assumptions used to determine the ARC, AOC, and Funded Status.

In addition, plan sponsors must provide 3 years of historical required supplementary information:

- Valuation dates
- Actuarial asset values
- Actuarial Liability
- Unfunded Actuarial Liability (excess Plan Assets)
- Plan funded ratio
- Annual covered payroll
- Ratio of unfunded Actuarial Liability (excess Plan Assets) to annual covered payroll
- Factors that significantly affect comparing the above information across the years.

Defining the Plan

GASB 45 refers to the *substantive plan* as the basis for accounting. It may differ from the *written plan* in that it reflects the employer's cost sharing policy based on:

- Past practice or communication of intended changes to a plan's cost sharing provisions, or
- Past practice of cost increases in monetary benefits.

The substantive plan is the basis for requiring recognition of potential future plan changes. This approach requires entities to acknowledge the underlying promise, not just the written plan.

What if retirees participate in the active healthcare plan, but are charged a rate based on composite active and retiree experience? (This was a contentious issue during the statement drafting, with one of the 7 board members dissenting from Board adoption of the final statement.) In general, GASB 45 requires recognition of the implied subsidy. However, if benefits are provided through a community rated plan (premium rates based on experience of multiple employers rather than a single employer), and the same premium is charged for active and retired participants, it is appropriate to value unadjusted premiums.

Actuarial Assumptions and Discount Rate Requirements

Under GASB 45, the actuary must follow current actuarial standards of practice, which generally call for explicit assumptions – meaning each individual assumption represents the actuary's best estimate.

GASB 45 also requires basing the discount rate on the source of funds used to pay the benefits. This means the underlying expected long-term rate of return on Plan Assets for funded plans. Since the source of funds for unfunded plans is usually an agency's general fund, and California and most other state law restricts what investments agencies can have in their general fund, unfunded plans will need to use a low (for example, 4% to 5%) discount rate. If an agency sets up a Trust and diversifies Trust Plan Assets, however, the discount rate might be much higher (such as 7%) depending on the Trust fund's expected long-term investment return.

Action Step

➔ Meet with your actuary to discuss the underlying actuarial methods and assumptions. This important meeting can avoid problems down the road.

Transition Issues
Typically, new accounting standards allow transition from old to new requirements. Because historical ARC calculations will rarely be available, GASB 45 takes a prospective transition approach: there is no requirement for an initial transition obligation. But if AOCs, before transition, were calculated consistently with the standard, a NOO at transition can be established at an agency's discretion.

Valuation Frequency Requirements and Small Plans
GASB 45 requires an actuarial valuation at least every 2 years for plans with more than 200 (active, inactive, and retired) members. Plans with fewer than 200 members will need a valuation every 3 years. In a significant departure from prior standards, though, GASB 45 allows plans with fewer than 100 members to elect a simplified measurement method – not requiring an actuarial certification.

HOW BIG IS THE PROBLEM?
Public sector retiree healthcare promises vary considerably across agencies and can be measured in several ways, for example:

- ARC as a percent of payroll
- Present Value of Benefits (PVB) as a percent of payroll or perhaps as a percent of general fund budget
- Unfunded liability (in most cases, the Actuarial Liability – AL) as a percent of payroll or perhaps as a percent of general fund budget.

We believe the biggest issue is GASB 45 *requiring agencies to disclose unfunded OPEB liabilities in financial statement footnotes.* Consequently, unfunded liabilities in relation to payroll or budget will become important for bond rating agencies. The table below shows examples based on recent actuarial studies we've prepared (although agency demographics vary widely, all calculations were prepared in compliance with GASB 45).

	% Payroll			**% Annual General Fund Budget**		
Basic OPEB Promise	**ARC**	**PVB**	**AL**	**ARC**	**PVB**	**AL**
1a. Full medical coverage for retiree and spouse – Plan Assets not diversified	28%	369%	192%	19%	258%	135%
1b. Full medical coverage for retiree and spouse – Plan Assets diversified	17%	208%	126%	12%	146%	89%
2a. Medical coverage, capped at $450/month with no increase in cap	9%	115%	85%	7%	92%	68%
2b. Medical coverage, capped at $450/month with increase in cap	12%	145%	107%	9%	116%	86%
3. Minimum (2005 $48.40/month) PEMHCA payment	2%	30%	20%	2%	23%	15%

These examples lead to some interesting questions and conclusions, providing some insight on magnitude. For example:

- 1a. and 1b. show the significant impact of diversifying Plan Assets (in a Trust, separate from agency's general fund that legally can be used only to pay OPEB) and not diversifying Plan Assets invested in agency's general fund. While this difference is significant and prefunding may be fiscally prudent, we do not expect many agencies will do so. Prefunding will mean allocating cash and most agencies will find this challenging.

- Agency 1's unfunded Actuarial Liability is quite significant, while Agency 3's is quite modest. Although we don't know how bond rating agencies will react to the added information, it's reasonable to assume that, with all other things the same, Agency 1 might experience more of an impact than Agency 3.
- The addition of a COLA (cost-of-living adjustment) to Agency 2's promise increases their ARC and Actuarial Liability by approximately 1/3. Remember GASB 45 mentions the underlying promise. Consequently, even if there is no express agreement to increase the $450 cap in the future, if it's reasonable to believe it *will* increase, the calculations must assume it will.
- An older agency (with a high ratio of retirees to actives) will have higher percents than shown in the table, while a younger agency (with very few retirees) would have lower percents.

Action Step

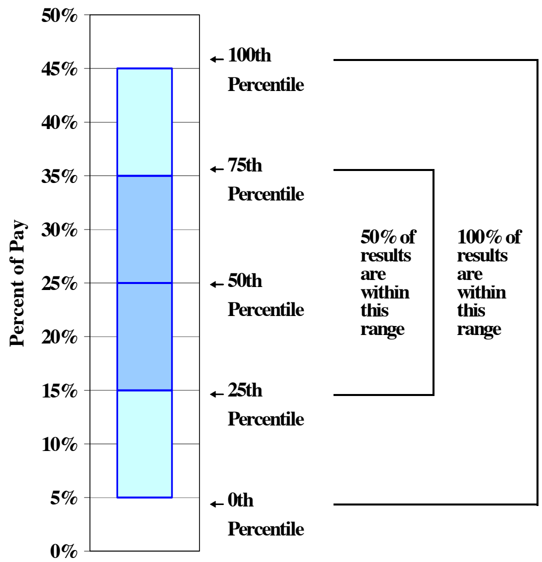
➔ Once you understand how significant your OPEB issue is, consider discussing these results with bond rating agencies, bargaining units, and city councils (or governing boards). Reviewing liabilities now gives you time to address the magnitude before GASB 45 is effective.

The following graphs compare the over 70 Miscellaneous and Safety GASB 45 studies prepared by Bartel Associates.

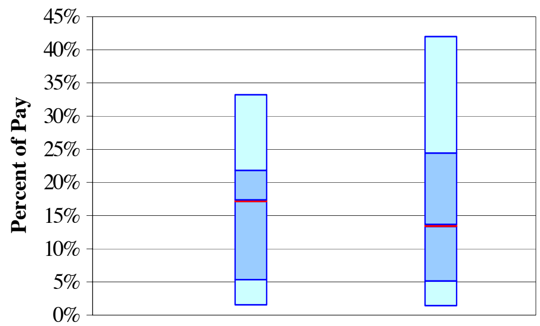
The first graph provides sample percentiles for interpreting the information that follows. All graphs provide the 0^{th}, $25^{th,}$ 50^{th}, 75^{th} and 100^{th} percentiles (the X^{th} percentile is the level at which X percent of the data fall below the given level – for example 25% of the data falls below the 25^{th} percentile). As noted on this chart, the dark shaded area in the middle of the column includes results between the 25^{th} and 75^{th} percentiles representing 50% of the agencies, with the line in the middle indicating the 50^{th} percentile.

The other graphs compare Normal Cost (NC), Annual Required Contribution (ARC) and Actuarial Liability (AL) as a percentage of payroll for Miscellaneous and Safety employees.

GASB 45 Survey
Sample Percentile Graph

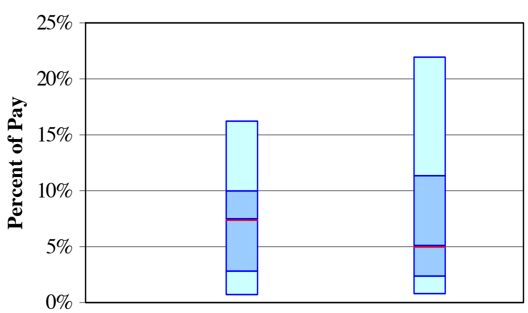


GASB 45 Survey
Annual Required Contribution
(% of Payroll)



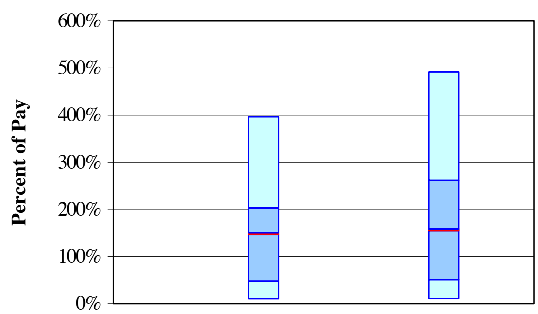
	Miscellaneous	Safety
100th Percentile	33.2%	42.0%
75th Percentile	21.8%	24.4%
50th Percentile	17.4%	13.4%
25th Percentile	5.4%	5.1%
0th Percentile	1.5%	1.4%

GASB 45 Survey
Normal Cost
(% of Payroll)



	Miscellaneous	Safety
100th Percentile	16.2%	22.0%
75th Percentile	10.0%	11.4%
50th Percentile	7.5%	5.1%
25th Percentile	2.8%	2.4%
0th Percentile	0.7%	0.8%

GASB 45 Survey
Actuarial Liability
(As % of Payroll)



	Miscellaneous	Safety
100th Percentile	396%	491%
75th Percentile	203%	261%
50th Percentile	147%	158%
25th Percentile	48%	51%
0th Percentile	11%	11%

The cost information shown represents primarily *unfunded* retiree medical plans since most of these agencies are in the process of deciding whether to fund their plans. When a significant number of our clients have made that decision, we will be able to separate the statistics by funded and unfunded plans.

The reader should keep in mind the results are not a statistical sample of all California agencies and so results based on all California agencies will vary from our client base.

CONCLUSION

There's no doubt GASB 45 will cause major changes for plan sponsor disclosure. The way to soften the blow is *not* waiting for the effective date. Contact your actuary well in advance to understand the implications, get started on action steps, and establish a plan for compliance.

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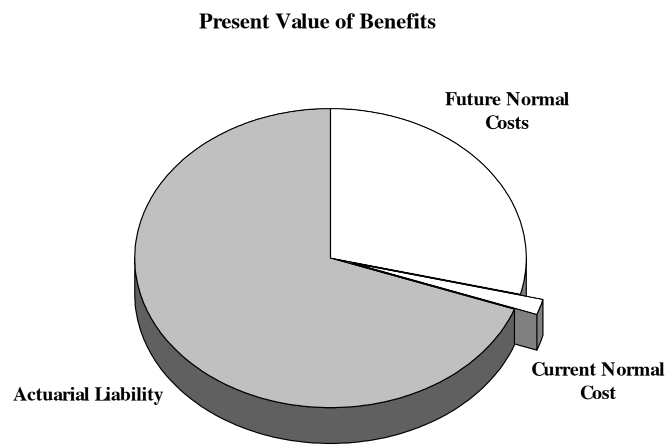
ACTUARIAL DEFINITIONS



Present Value of Benefits: An actuary preparing an actuarial valuation first gathers participant data (active employees, former employees not in payment status, participants and beneficiaries in payment status) at the valuation date (for example June 30, 2005). Using this data and some actuarial assumptions, the actuary projects future benefit payments. (The assumptions predict, among other things, when people will retire, terminate, die, or become disabled as well as what salary increases, general (and healthcare) inflation, and investment return might be.) Those future benefit payments are discounted, using expected future investment return, back to the valuation date. This discounted present value is the plan's Present Value of Benefits. It represents the amount the plan needs as of the valuation date to pay all future benefit payments – if all assumptions are met.

Actuarial Liability: This represents the Present Value of Benefits portion participants have earned (on an actuarial, not actual, basis) through the valuation date.

Funded Status: Once the above amounts are calculated, the actuary compares Plan Assets to the Actuarial Liability. When Plan Assets equal liabilities, a plan is considered on track for funding. When Plan Assets are greater than liabilities, the plan has excess Plan Assets. When Plan Assets are less than liabilities, the plan has an unfunded Actuarial Liability.

Normal Cost: This represents the Present Value of Benefits expected to be earned (on an actuarial, not actual, basis) in the coming year.

Plan Assets: GASB 45 requires that to consider an OPEB plan funded, assets must be set aside and cannot legally be used for any purpose other than to pay OPEB. Most OPEB plans are not funded.

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