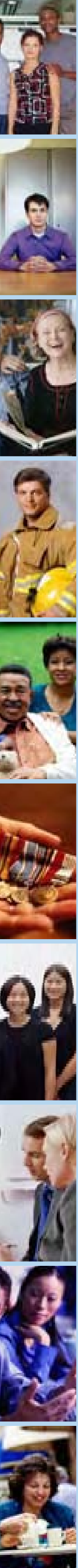

OPEBs & GASB 45

A Question and Answer Guide

California Debt and Investment Advisory Commission

CDIAC #06-09

OPEBs & GASB 45:

A Question and Answer Guide

One significant fiscal challenge facing many state and local governments is funding and accounting for other post-employment benefits (OPEBs) for current and retired employees, particularly in light of Governmental Accounting Standards Board (GASB) Statement Number 45 (known as "GASB 45"). Typically, public agencies have reported the cost of retiree heath care and other non-pension benefits on a "pay-as-you-go" basis. The annual cash paid for benefits has been the annual expense with no other liabilities or funding requirements reported. GASB states that the current "pay-as-you-go" method does not accurately reflect the true costs that governments are accumulating for future benefits of current employees. According to GASB, the promise of future benefit is an expense that must be recorded rather than deferred as a liability to a future generation.

What is GASB 45?

GASB's new accounting standards for OPEBs, GASB 45, applies to all public agencies (e.g., state governments, county and city governments, school districts) that follow generally accepted accounting principles (GAAP) in filing their annual financial statements and offer post-employment benefits other than pensions. Under GASB 45, public agencies must account for, and report, the annual required contribution (ARC) for OPEBs in the same way they report pension benefits. As a result, the annual OPEB expense to be reported by most employers will need to be based on actuarially determined amounts rather than on the "pay-as-you-go" method. Governments must use actuarial evaluations to determine the final accounting and reporting amounts expected in the future. OPEB costs also must be reported over the working lifetime of employees, and the information provided in financial statements must include the funding, costs and provisions in an OPEB plan. While GASB 45 does not require that OPEB plans be funded, it requires disclosure of net OPEB obligations (NOO).

GASB 45 Implementation

Implementation of GASB 45 will be in three phases: public agencies with revenues of $100 million or more per year must comply with GASB 45 beginning the fiscal year after December 15, 2006, those with revenues of $10 million to $100 million must comply beginning the fiscal year after December 15, 2007, and those with revenues of less than $10 million must comply beginning the fiscal year after December 15, 2008.

With theses dates approaching, CDIAC has compiled this Guide to address some basic questions regarding GASB 45 implementation. Because GASB 45 will require public agencies to disclose the NOO on their financial statements, public agencies need to address questions regarding the handling of any net OPEB obligations. This Guide compiles basic information on options for addressing OPEB liabilities.[1] In addition, the Guide concludes with a list of sources used as the basis for much of the information found in this document.

What are OPEBs?

OPEBs provided to retirees, spouses, and their dependents, generally include:

- Medical benefits
- Dental benefits
- Vision-care benefits
- Prescription medicine benefits
- Life insurance benefits
- Disability insurance benefits
- Group legal coverage benefits
- Long-term health care benefits
- Other health benefits – if not part of a pension plan

What are not OPEBs?

OPEBs generally do not include:

- Pension income benefits
- Sabbaticals
- Vacation benefits
- Sick leave benefits
- Consolidated Omnibus Budget Reconciliation Act (COBRA) benefits
- Special termination benefits (unless the effect is an increase in benefits that are OPEBs)

Should a public agency do anything before the GASB 45 effective date?

If the public agency is concerned about the impact on financial reports or the potential reaction of the financial community, a preliminary liability and expense analysis performed well in advance of the effective date may assist in addressing this concern. These amounts will need to be disclosed in connection with the public agency's note or bond offerings. A preliminary liability and expense analysis might allow the agency to be better equipped to understand and manage its OPEB obligations in advance of its financial statement disclosure deadlines.

What method is currently used in the public agency to account for the cost of benefits for retired employees?

Generally, most public agencies have been using a "pay-as-you-go" method of expensing retiree benefits and have not reported them as liabilities on their financial statements. GASB 45 will require public agencies to account for OPEBs as liabilities, and report them on their financial statements as the obligations accrue, regardless of how the agencies elect to budget and pay for these obligations.

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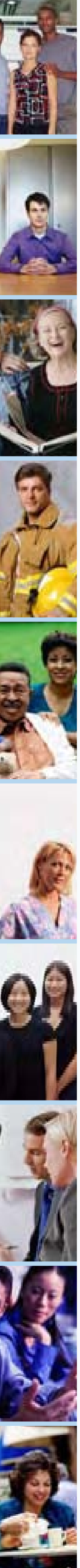
[1] *CDIAC does not specifically endorse any of the options contained in this publication; it encourages public agencies to consult with their legal counsel before pursuing any of the options identified.*



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What information is required to be reported under GASB 45?

GASB 45 requires that organizations calculate and record the expense of their OPEB plans. These required calculations include the determination of the ARC and the NOO.

According to GASB, the **ARC** is the "annual required contribution" or the employer's required contribution for the year, calculated in accordance with certain parameters.

- The **ARC** is the sum of the "normal cost" (the portion of the present value of estimated total benefits that is attributed to services received in the current year) and the amortized unfunded actuarial accrued liability (UAAL)[2] (the cost of those same employees for past, unfunded years of service). The ARC, in effect, recognizes that retiree health benefits are "earned" and are financial obligations accrued during an employee's entire period of service.[3]

The **NOO** is based on the difference between the ARC and the amount actually contributed.

- The NOO is calculated annually and changes are based on the accumulated contributions and the accumulated ARC. At the end of the year, the NOO equals the summation of beginning of the year NOO, the annual OPEB cost, and the actual contribution. If the accumulated contributions:
  1) *Equal* the accumulated ARC, then NOO is zero (this would imply that the plan is starting to be pre-funded).
  2) Are *greater* than the accumulated ARC, then NOO is less than zero, creating an asset on the books of the government.
  3) Are *less* than the accumulated ARC, then NOO is greater than zero, creating a reportable liability for GASB 45 purposes.

Note: *GASB 45 will only recognize an employer contribution if it is deposited into a GASB 45 qualified trust or equivalent arrangement.*

How can an agency determine its OPEB liability?

To estimate the liability of retiree OPEB benefits, public agencies should have an actuarial valuation performed. Under GASB 45, an actuarial valuation generally will be needed every two or three years, depending on the number of plan participants.

Is an actuarial valuation necessary under GASB 45?

An actuarial valuation is generally required for all plans having at least one participating employer with more than 100 members (including employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retirees and beneficiaries currently receiving benefits).

[2] *The UAAL will likely appear as a footnote to the financial statements.*

[3 & 4] *See GASB, GASB **Implementation Guide: Statements 43 and 45 Questions and Answers** (2005).*

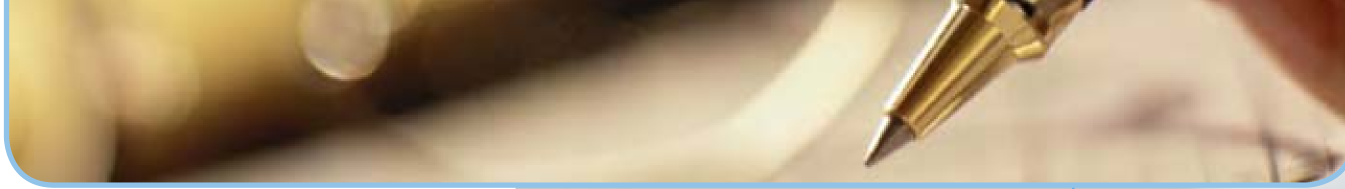
What actuarial methods are available?

GASB 45 permits a choice of six actuarial cost methods to determine the annual expense. According to GASB, demographics, the level and amount of OPEBs, and the funding status of the plan generally influence the actuarial method chosen. The public agency's actuary will review these factors and recommend the best method given the agency's particular situation. In practice, many actuaries prefer to use the "unit credit" actuarial cost method, under which an employee is assumed to earn a unit benefit for each year employed, with all benefits assumed accrued upon retirement.[4]

What options other than modifications to existing plans does a public agency have for funding its OPEB liabilities?[5]

- **Continue "Pay-As-You-Go" Funding.** While making annual payments towards annual OPEB costs is the simplest method in the short run, the "pay-as-you-go" method in the long run may result in annually increasing NOO for GASB 45 reporting purposes. This may occur because the investment return assumptions used in the OPEB calculation for the "pay-as-you-go" method likely will be based on the public agency's general operating fund investments, which usually are based on a shorter investment horizon (and thereby, generally lower rates of return) than the investment horizon for certain trust funds (*see below*).
- **Pre-funding OPEB Liability.** Pre-funding an account (e.g., making annual payments consistent with the ARC) can allow the public agency to allocate funds for the express purpose of funding future OPEB costs. The investment returns can be used to reduce the ARC and can result in lower long-term costs. Pre-funding amounts may be deposited in either:
  1) ***Dedicated Fund.*** This fund is a separate fund set up within the public agency's treasury. However, in order for funds to be counted towards the ARC for GASB 45 purposes, they must meet certain conditions (*see answer to the question* "What are the basic features of an OPEB trust?"). Therefore, revenues deposited in internal funds will still be treated as "pay-as-you-go" funding for GASB 45 accounting purposes.
  2) ***Trust Fund.*** GASB 45 does not require liabilities to be funded through an irrevocable contribution; however, the rules applied under GASB 45 make the use of an irrevocable trust beneficial to the public agency (*see below for more information on OPEB*

[5] *This question addresses methods of meeting whatever OPEB liabilities exist, as determined by the public agency. It does not address what legal obligations exist, nor does it address whether or how a public agency might consider modifying existing OPEB plans or practices. There remain divergent views about the nature and extent of public agencies' obligations to maintain OPEB benefits. Circumstances are unique for each public agency, and such questions likely would require consultation with legal counsel and possibly negotiation and agreement among representatives from all affected parties.*



trusts). These trusts may be funded through various means (*see below for examples of funding sources*).

What are the basic features of an OPEB trust?

In order for a trust to be properly structured to fund OPEBs for GASB 45 reporting purposes, it should have the following features:

- **Tax Exemption.** Investment trust assets must be held by a tax-exempt entity so that contributions may not be considered as income to the employee or retiree under federal and state income tax laws. Also, income on investment of trust assets must be exempt from taxation.
- **Meet the Requirements of GASB 45.** Contributions must be irrevocable, protected from creditors, and limited to the funding of benefits to retirees, spouses, and their dependants as specified in the public agency's OPEB plan.
- **Investment in a Wider Variety of Securities.** Many public agencies are restricted by state law and the California Constitution to a narrow range of low-risk, primarily short-term, fixed-income investments for their operating funds. OPEB trusts should be structured to allow investment in long-term securities, such as equities, that match the long-term nature of the obligations and therefore may provide higher investment returns over the life of the trust.

What types of OPEB trusts are available?

There are multiple categories of OPEB trusts:

- A **Section 401(h) account** is a separate account established within a qualified pension plan dedicated to pay health benefits for retirees, spouses and their dependents. Contributions to the account may not exceed 25 percent of total pension contributions after the date on which the account is established.
- A **Section 115 trust** is considered exempt from federal income tax either because it is an "integral part" of a single governmental entity or because it serves an "essential governmental function" of one or more governmental entities.
- A **Section 501(c)(9) trust** is considered exempt from federal income tax. Also known as Voluntary Employees' Beneficiary Associations, these are separate trusts designed specifically to pay OPEB benefits.

What are the potential funding sources for OPEB obligations?

Categories of potential funding sources for OPEB obligations include, but are not limited to, the following:

- **General Fund and Reserve Funds.** If a public agency decides to set aside revenues for OPEB funding, various existing revenue sources may be used to fund the costs.
- **OPEB Bonds.** See details below.
- **Medicare Part D Subsidies.** Qualifying employers who continue to provide prescription drug coverage to Medicare beneficiaries receive a 28 percent federal government subsidy if their employer sponsored health care benefit plan provides coverage that is equivalent to that provided under Medicare. Employers may choose to dedicate subsidy proceeds to pay for broader retiree health care costs.

What is an OPEB bond?

Legal authority for OPEB bonds will vary from entity to entity within a state.[6] For some public agencies, OPEB bonds may generally be structured like pension obligation bonds. That is, they may be issued, depending on the public agency, as a federally taxable bond to refund an existing obligation such as an OPEB unfunded liability. In such cases, the bonds would be issued with the expectation that the bond proceeds will be invested at a rate of return that exceeds the total cost of borrowing. The desired result is that the transaction reduces the public agency's total OPEB costs, such that total debt service plus any remaining ARC is less than the total payments that would have existed if the bonds were not issued. By applying the higher interest rate assumption to the increased amount invested, a public agency may reduce the overall amount of its UAAL and ARC.

What are the advantages/disadvantages to issuing an OPEB bond?

Advantages. Advantages to issuing an OPEB bond may include:[7]

- Interest rate savings (bond interest costs may be less compared to the investment return assumption used in calculating the UAAL and ARC).
- Investment earnings (rate of return may exceed the yield on the bonds generating higher net income).
- Possible budget relief as compared to "pay-as-you-go" funding (debt service can be tailored to meet budget targets).
- Positive overall credit rating implications (because the OPEB liability is being addressed proactively).
- Reduced UAAL and ARC (achieved through higher investment return expectations).

[6] *See Orrick Herrington & Sutcliffe, LLP, Other Post-Employment Benefits—The Next Big Financial, Disclosure, Accounting and Public Relations Challenge Affecting State and Local Governments (2006).*

[7] *See Orrick Herrington & Sutcliffe, Other Post-Employment Benefits—The Next Big Financial, Disclosure, Accounting and Public Relations Challenge Affecting State and Local Governments (2006) for a discussion of some of these points.*

- Lower long-term costs of OPEBs (while debt service funding may be higher than pay-as-you-go funding in the early years, debt service funding will be predictable, while required "pay-as-you-go" funding costs may rise unexpectedly in the future).

Disadvantages. Disadvantages to issuing an OPEB bond may include:

- Concentration of investment risk (may result due to lump sum contribution from bond proceeds as compared to spreading the investment risk (e.g., "dollar cost averaging") by making ARC deposits over time).
- Potential negative arbitrage (could occur if unfavorable market conditions develop such that returns consistently fall below cost of funds).
- Replacement of a theoretically negotiable OPEB obligation with an absolute bond obligation.

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