



## **GASB ISSUES FINAL STATEMENTS ON ACCOUNTING FOR OTHER POSTEMPLOYMENT BENEFITS BY STATE AND LOCAL GOVERNMENTAL EMPLOYERS**

*The Governmental Accounting Standards Board (GASB) issued two new final statements recently – Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (Statement No. 45 issued June 2004 and released August 2, 2004) and Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans (Statement No. 43 issued April 2004). These statements establish standards of accounting and financial reporting for other postemployment benefits (OPEBs) expenditures/expense and certain other related amounts in the financial reports of state and local governmental employers and OPEB plans. This For Your Information discusses the key provisions of the two statements. For most plan sponsors, the statements will require a significant increase in current expense for OPEBs.*

### **BACKGROUND**

In May 1990, GASB issued Statement No. 12, *Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers*. This was an interim measure designed to provide some information on postemployment benefits other than pensions while GASB continued its “project on recognition and measurement of OPEB expenditures/expenses and liabilities or assets.” This statement dealt with disclosure only and had no impact on how employers were accounting for and reporting on OPEBs.

In November 1994, GASB issued Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*, as part of its pension accounting project. This was another interim measure designed to clarify the disclosure requirements for pension plans that also administered retiree healthcare benefits. Its goal was to provide minimal reporting for certain OPEB plans that would be presented in a manner consistent with reporting for pension benefits under Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*.

In February 2003, the GASB issued two Exposure Drafts dealing with OPEBs that were the first step in the process leading to the new statements. The first detailed accounting and financial reporting requirements for state and local governmental employers who provide OPEBs to their employees. The second covered financial reporting by OPEB plans. The former was reissued on January 30, 2004 after commentary GASB received regarding the treatment of retiree healthcare implicit rate subsidies (see below).

The new statements supersede Statements No. 12 and 26, and provide a standard framework for accounting and financial reporting for both defined benefit and defined contribution OPEB plans, regardless of the sponsoring entity or underlying plan structure.

## **THE STATEMENTS IN GENERAL**

The statements govern the accounting treatment for OPEBs, including both –

- postemployment healthcare benefits, whether provided separately or through a defined benefit pension plan
- other forms of non-pension postemployment benefits (e.g., life insurance, disability, long-term care) unless provided through a defined benefit pension plan.

***COMMENT.** The provisions of the statements are quite broad and cover not only retirees but also certain other terminated employees such as those who are on long-term disability (LTD). If any of the OPEBs other than healthcare are provided through a defined benefit pension plan, they are covered by GASB Statements No. 25 and No. 27.*

The approach adopted by GASB for the standards is generally consistent with the approach taken in Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans* and Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*. The statements require the measurement and recognition of the annual OPEB costs on an accrual accounting basis. In addition, disclosure information regarding the funding, costs and provisions of the OPEB plans is required. Currently, most nonpension postemployment benefits are financed on a pay-as-you-go basis and have not been reported in financial statements until paid.

Termination offers and benefits that are deemed incentives to terminate employment are not considered OPEBs. However, the statements cover a change in the obligation by an OPEB plan to pay benefits already earned as a result of an early termination offer.

## **STATEMENT FOR EMPLOYER ACCOUNTING**

### **Scope**

Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, applies to all state and local governmental entities that provide or participate in OPEB plans – including public benefit corporations and authorities, utilities, hospitals and other healthcare providers,

colleges and universities and PERS that are employers. These requirements apply whether the employer issues separate financial reports or whether its financial statements are included in the financial reports of another governmental entity. The statements have very different requirements for multiple-employer plan sponsors that participate in plans covering all employees on a pooled basis (cost-sharing multiple-employers) from those where plan benefits and assets are accounted for separately (agent multiple-employers).

### ***Sole and Agent Employers***

Employers that participate in single-employer and agent multiple-employer defined benefit OPEB plans are required to measure and disclose an amount for annual OPEB cost on the accrual basis of accounting, regardless of the amount recognized as OPEB expenditures/expense in the financial statements. Annual OPEB cost would be equal to the employer's annual required contribution (see below) to the plan, unless the employer has a net OPEB obligation for past under- or over-contributions.

### ***Cost-Sharing Multiple-Employers***

Cost-sharing multiple-employer plans cover all employees of participating governments on a pooled basis where the costs of financing benefits and assets are shared by participating employers. Employers that participate in these plans are required to recognize OPEB expenditures/expense equal to the employer's contractually required contributions as well as a liability for unpaid contributions. Recognition is on the modified accrual or accrual basis, depending on the fund type or type of entity.

### ***Annual Required Contribution***

The measurement of the annual OPEB cost is based on the concept of annual required contribution (ARC), which consists of the normal cost and a portion of the total unfunded actuarial accrued liability (UAAL). The normal cost and UAAL are derived from the actuarial present value of benefits, the actuarial cost method and the plan assets. The determination of the ARC must be in accordance with the following parameters.

### ***Actuarial Valuations***

The statement indicates that actuarial valuations for covered plans should be performed at least biennially for plans with a total membership (i.e., active and retired employees) of 200 or more, and at least triennially for those with a total membership under 200. The actuarial valuation date should not be more than 24 months before the beginning of the fiscal year of the employer (first fiscal year of the cycle, if biennial or triennial valuations are performed). A new actuarial valuation should be performed if there have been significant

changes since the previous valuation (e.g., significant changes in benefit provisions, or the size/composition of the population covered by the plan). A significant product of the actuarial valuation is the actuarial present value of total projected benefits, which is based on the substantive plan, per capita costs, interest rate and other assumptions outlined below.

The GASB also included an alternative measurement method for sole employers in plans with fewer than 100 members. The alternative permits, but does not require, sole employers to elect certain simplifying modifications regarding the selection of assumptions. The intent of these modifications is to permit affected employers to estimate the liability and contribution amounts necessary to meet the accounting and financial reporting requirements of the statement without the assistance of outside actuaries and consultants.

### *Substantive Plan*

The statement requires OPEB costs to be based on the substantive plan – that is, the plan as understood by the employee and employer. Plan provisions for retiree healthcare benefits are evolving continuously in the face of a changing healthcare marketplace, new plan designs (e.g., consumer-driven plans, Medicare Advantage plans) and cost-sharing arrangements. In many cases, the written plan is out-of-date or does not describe the nature of the cost-sharing arrangements and other plan provisions thoroughly (e.g., eligibility). Therefore, GASB decided that the basis for the calculations should consider not only the written plan, but also the benefits as communicated to plan members. In addition, the substantive plan should reflect expected future changes in the cost-sharing plan features where the employer has established a past practice of periodic changes in this area.

***COMMENT.** In a change from the initial Exposure Draft, the scope of the statement specifically includes OPEB plans with implicit rate subsidies for retirees even if the employer does not otherwise contribute to the cost of the OPEB. These implicit subsidies arise when both active employees and retirees are covered by the plan and the average cost for all participants is charged to participating retirees. In this case, the projection of future retiree liabilities should be based on claim costs or age-adjusted premiums. Special rules apply for community-rated plans.*

*In addition, the statement makes it clear that benefit caps may be taken into consideration when determining OPEB liabilities but funding caps may not. For example, a plan that limits the employer share of retiree healthcare costs to \$300 per month per retiree would use that cap in projecting expected future benefit payments, while a plan that limits the employer contribution towards financing retiree healthcare benefits to 5% of active employee payroll would ignore that limitation in developing*

*OPEB liabilities and resulting required contributions. The latter situation would call for additional disclosures, however.*

### *Interest Rate Assumption*

The statement indicates that the investment return assumption should be the expected long-term rate of return on the investments used to finance the OPEB. Thus, the assumption would be based on plan assets for plans in which the sponsor is contributing the ARC, or on general employer assets for plans where no assets have been accumulated. A blended rate is to be used for plans where some assets have been accumulated but the plan sponsor is contributing less than the ARC.

***COMMENT.** Since general employer assets are typically restricted to short-term fixed income investments, this would appear to produce the anomalous result that unfunded plans would generate greater liabilities than identical funded plans.*

### *Per Capita Costs and Other Actuarial Assumptions*

The statement indicates that the per capita health care costs and all assumptions, including the healthcare cost trend rate, should be guided by Actuarial Standard of Practice No. 6, *Measuring Retiree Group Benefit Obligations* issued by the American Academy of Actuaries. In addition, GASB has included a specific requirement that the assumed inflation rate be the same in all the economic assumptions. The statement also requires single and agent employers to disclose the inflation, interest, healthcare trend rate and projected salary increase assumptions. If any of the economic assumptions vary by year (e.g., healthcare trend rates), the initial and ultimate rates are to be disclosed.

### *Actuarial Cost Method*

The actuarial present value of benefits is to be allocated over past and future years based on any one of the acceptable actuarial cost methods. These methods include entry age, frozen entry age, attained age, frozen attained age, projected unit credit or aggregate. They are the same methods as those used for pension accounting and reporting.

***COMMENT.** There is no requirement that the cost method used for OPEB be the same as that used for pensions. The available methods all budget for the OPEB liability, but each generates a different cost pattern over time. These patterns should be studied before selecting a method.*

### *Actuarial Value of Assets*

The method for determining the actuarial value of assets should be consistent with the class and anticipated holding period of the assets, the interest rate assumption, other assumptions used in determining the actuarial present value of pension benefits, and current actuarial standards for asset valuation. Also, the actuarial asset value generally should reflect market value but the use of current market value would not be appropriate if it causes unreasonable volatility in the ARC from a long-term perspective. Thus, investments in securities should be valued using methods that smooth the effects of short-term volatility in market value over, for example, a period of 3 to 5 years. Amortized cost could be used for fixed-income securities if, for example, the plan intends to hold them to maturity.

### *Maximum Amortization Period for the UAAL*

The UAAL is the excess of the actuarial accrued liability over the actuarial value of assets. The statement establishes a maximum acceptable amortization period of 30 years for the UAAL. When components of a plan's total UAAL are amortized over different periods, the equivalent single amortization period cannot exceed the maximum amortization period.

Because so few OPEB plans are currently advance funded, the GASB did not see a reason to set a higher maximum amortization period during initial transition. Therefore, there is no provision similar to the 40-year maximum under the pension Statements No. 25 and No. 27.

### *Minimum Amortization Period*

In addition to the maximum acceptable amortization period of 30 years for unfunded actuarial liabilities, the statement requires that significant gains produced by a change in the actuarial cost method or in the asset valuation method be amortized over at least ten years, unless the plan is closed to new entrants and all or almost all of the plan members have retired.

### *Amortization Method*

The provision for amortizing the total unfunded actuarial liability may be determined in level dollar amounts or as a level percentage of the projected payroll of active plan members. If the level percentage of projected payroll method is used, the assumed payroll growth rate should not include an assumed increase in the number of active plan members. However, projected decreases in that number should be included if the plan is closed to new members.

### ***Transition and Net OPEB Obligation***

The statement permits, *but does not require*, employers with actuarial information for prior years to calculate their net OPEB obligations at transition. The ongoing net OPEB obligation is the amount recognized at transition plus any cumulative difference between the annual OPEB cost and the employer's contributions. If an employer has a net OPEB obligation, the annual OPEB cost should be equal to the ARC, one year's interest on the net OPEB obligation, and an adjustment to the ARC to reflect the net OPEB obligation already recorded on the financial statements.

***COMMENT.*** *For the vast majority of employers who have been financing OPEBs on a pay-as-you-go basis, the best course would be to set the net OPEB obligation at transition to zero.*

### ***Special OPEB Funding Situations***

Some employers participate in OPEB plans without being legally responsible for making employer contributions. In this situation, the entity that is legally responsible for the contributions should recognize OPEB expenditures/expense and related liabilities or assets in accordance with the statement.

### ***Employer Disclosure Requirements***

In addition to recognizing the ARC and any net OPEB obligation in its financial statements, employers are required to provide additional information for each defined benefit OPEB plan in which they participate regarding the operation of the OPEB plan in notes to the financial statements, including a description of the plan and the funding policy. Sole and agent employers are required to provide additional note disclosure (required supplementary information or RSI) that do not apply to cost-sharing employers. Sole and agent employers are also to provide RSI concerning funding progress and trends affecting the amounts reported for the most recent actuarial valuation and the two preceding valuations.

Cost-sharing employers that participate in plans that do not issue plan financial reports would be required to present certain RSI in their own financial reports. This RSI would include schedules of funding progress and employer contributions for the plan as a whole (see below for further details on these schedules).

### **Insured Plans**

For insured plans, employers must recognize OPEB expenditures/expense equal to their annual premiums. For purposes of the statement, an insured plan is one in which the employer pays premiums to an insurance company while employees are working, in return for which the insurance company unconditionally undertakes an obligation to pay the OPEB benefits.

***COMMENT.** The provisions of the statement are quite broad and cover plans such as long-term disability (LTD) plans. If LTD benefits are insured, the employer recognizes the premium, which represents the cost of those becoming disabled in the next year. However, if the LTD plan is not insured, the employer must recognize a cost based on a portion of projected benefits payable due to disabilities in the future for its entire current workforce. Depending upon the demographics of the population and the actuarial cost method selected, this amount could be much larger than a typical insured premium.*

### **Defined Contribution OPEB Plans**

The statement requires employers with defined contribution plans to recognize annual OPEB expenditures/expense equal to their required contributions and to provide minimal note disclosure.

### **STATEMENT FOR PLAN ACCOUNTING**

Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, establishes financial reporting standards for defined benefit OPEB plans. Standards for the notes to the financial statements of defined contribution OPEB plans are covered in GASB Statement No. 25.

### **Scope**

Defined benefit OPEB plans are to report current financial information about plan assets and financial activities, actuarially determined information about the funded status of the plan, and the progress being made in accumulating assets to pay the promised benefits when due. The statement requires the information to be presented in two financial statements and two required schedules of historical trend information.

Statement No. 43 only applies to plans that are accumulating assets through a trust or other third-party entity to pay benefits as they come due. Thus, pay-as-you-go plans do not have any reporting requirements of their own (however, employers are required to provide RSI as supplements to their own statements).

### **Financial Statements**

The two required financial statements are a statement of plan net assets and a statement of changes in plan net assets. These statements should be prepared on an accrual basis and show assets at fair value. They are to be accompanied by notes that are to include a brief plan description, a summary of significant accounting policies, information about contributions, reserve and investment concentrations, and a description of funding status and funding progress.

### **Required Supplementary Information**

The first required schedule is a schedule of funding progress. This schedule should present, at a minimum for the most recent valuation and two preceding valuations, the following information –

- actuarial valuation date
- actuarial value of assets
- actuarial accrued liability
- unfunded actuarial accrual liability (UAAL)
- funded ratio
- annual covered payroll
- ratio of UAAL to annual covered payroll.

The second required schedule is a schedule of employer contributions, which is to be presented again at a minimum for the most recent valuation and the two preceding valuations. This schedule is to include the dollar amount of the ARC applicable to that year and the percentage of the ARC that was recognized in the plan's statement of changes in plan net assets for that year as a contribution from the employer(s).

All dollar amounts in the two schedules are to be determined and calculated based on the same parameters included in Statement No. 45 related to employer accounting. However, employers that use the aggregate actuarial cost method should prepare the information in the schedule of funding progress using the entry age actuarial cost method.

***COMMENT.** The requirement that an employer using the aggregate actuarial cost method prepare the OPEB funding progress schedule using the entry age actuarial cost method differs from the approach used for pensions under GASB Statements No. 25 and No. 27. A schedule of funding progress cannot be produced under the aggregate actuarial cost method. GASB believes such a statement is important for*

*OPEB and thus, in this one case, has proposed that certain disclosure information be based on an actuarial cost method different from that used for funding the plan.*

## **EFFECTIVE DATES**

Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, is to be effective in three phases based on the phase for the governmental entity in implementing GASB Statement No. 34 –

- Phase I Governments - fiscal years beginning after December 15, 2006
- Phase II Governments - fiscal years beginning after December 15, 2007
- Phase III Governments - fiscal years beginning after December 15, 2008.

Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, is effective beginning in the fiscal year preceding the effective date of the employer statement for the largest participating employer in the plan. The phases are based on total revenue of the plan sponsor with the largest employers in Phase I.

## **NEXT STEPS**

Plan sponsors need to recognize that these statements are now final and that they will have a substantial impact on the entity's financial picture. Employers should start to address this issue by –

- taking an inventory of postretirement and postemployment benefits and classes of employees/retirees covered under the statements
- beginning to collect information regarding
  - o plan provisions of all covered plans, including past plan changes
  - o cost-sharing arrangements
  - o historical claims, premium and enrollment experience for covered plans, split by under/over age 65 members
  - o the access of pertinent census data for active and retired employees, including plan elections, coverage levels (e.g., single, 2 person, family), life insurance amounts, etc.
- performing a valuation to establish a baseline for future discussions regarding managing costs and possible funding. This valuation would use the information above and selected economic, demographic

and health care assumptions to determine the liabilities and annual contributions of the plan. Given the lead time necessary to establish budgets and to effect changes, this initial valuation should be done in the near future.

- exploring alternative benefits, contributions, eligibility and funding as necessary
- reviewing documents and employee communications to ensure they reflect the substantive plan.

## **CONCLUSION**

The accounting changes required by these statements will have important consequences for the financial statements of governmental employers. We expect that the size of the potential obligations will astound some employers. Moreover, the measurement of these costs is not an easy task, and there will be substantial work involved just in collecting all required data. Finally, it is likely that the magnitude of the costs involved may result in projects that examine plan design changes that make plans more affordable. Since this whole process is likely to take a good deal of time, we strongly recommend that all affected governmental entities start looking at their OPEB obligations, if they have not already done so.

Mellon's HR&IS consultants are ready to help you analyze the impact that these rules could have for your organization, and work through potential solutions to problems that may arise.

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