INTERNATIONAL MUNICIPAL LAWYERS ASSOCIATION



Work Session: Finance

Title: Issues Associated with GASB 43 and 45

by

Presenter: Amy S. Moskowitz

Presenter's Title: Associate County Attorney

Presenter's Office: Montgomery County, MD County Attorney's Office

© 2007 International Municipal Lawyers Association. This is an informational and educational report distributed by the International Municipal Lawyers Association during its 2007 Annual Conference, held October 28-31, 2007 in Nashville, Tennessee. IMLA assumes no responsibility for the policies or positions presented in the report or for the presentation of its contents.

Issues Associated with GASB 43 and 45

GASB/OPEB Introduction

The Government Accounting Standards Board ("GASB") is a private non profit organization responsible for establishing and improving accounting and financial reporting standards for non federal governmental units in the United States. Governmental units include states, counties, cities and other local governments, as well as organizations under those governments jurisdictions, such as public utlities, hospitals, universities and school systems. Although GASB does not have authority to enforce compliance with its standards, the Code of Professional Conduct of the American Institute of Certified Public Accountants (AICPA) recognizes these standards. The AICPA requires auditors to note any departures from GASB standards when issuing an opinion. Governments usually must prepare financial statements in accordance with those standards when they issue bonds or notes or borrow from public credit markets.

Many state and local governmental employers provide other post employment benefits (OPEB) after retirement. OPEB includes healthcare, as well as other benefits, such as life insurance. Currently, most governments fund these OPEB benefits on a pay-as-you-go basis ("PAYGO") and report these benefits only when paid and not over the period during which employees "earn" or accrue the benefits.

In 2004, to address concerns that using PAYGO does not account for the accrued cost of OPEB, GASB issued Statement 43 and 45 which requires governments to reflect the accrued costs on their financial statements. Statement 45 provides for reporting by governments whereas Statement 43 provides for reporting by the benefit plans. These Statements are similar to GASB Statements 25 and 27, issued in 1994 by GASB, which require governments to recognize pension benefits as they accrued in their financial statements. This is also similar to Statement 106, issued by FASB which requires private employers to recognize accrued OPEB costs in their financial statements.

Requirements

GASB 45 requires accrual basis recognition of OPEB costs over a period that approximates employees' years of service and information about liabilities associated with OPEB and information about the funding status of any OPEB.

The government must have an actuarial valuation to determine the liability (based on past benefits "earned" and benefits expected to be "earned" in the future). An actuary calculates the contribution the government must make in order to have the assets available to pay OPEB. The actuary discounts the contribution to the actuarial present value, the value if paid today, using a discount rate equal to an assumed long term rate of return on investments. The portion of the actuarial

valuation allocated to prior years of employment equals the actuarial accrued liability (AAL). If an OPEB plan has assets set aside in a trust, the actuarial value of the assets reduces the actuarial accrued liability. The actuarial value of the assets differs from the actual value of the assets because the actuary averages the gains and losses over several years (usually three to five). The excess of the AAL over the actuarial value of assets equals the unfunded actuarial accrued liability (UAAL). The actuary amortizes the UAAL over a period of up to thirty years, either in level dollar amounts or as a level percentage of projected payroll (or another accepted method). The normal cost of benefits for each year (PAYGO) and the portion of the amortized portion of the UAAL for the year make up the annual required contribution (ARC).

In order to complete the actuarial valuation, the actuary must use accepted actuarial assumptions. Actuarial assumptions include: (a) timing of projected future benefit payments; (b) turnover assumptions; (c) demographic information such as marital status and number of dependents; (e) mortality assumptions; (f) healthcare cost trend rate and health insurance premiums; (g) health care trends; (h) enrollment rates; (i) statement of net assets; and (j) discount rate assumption (investment return assumption) used to calculate the present value of future benefit payments. GABS requires actuarial valuations every two years for governments with more than 200 participants.

For a government in a single-employer or agent multiple-employer plan, the annual OPEB cost equals the ARC (plus or minus adjustments if the employer's actual contributions have differed from the ARC). The government reports the annual OPEB cost as the OPEB expense in its financial statements. Any difference between an employer's annual OPEB cost and the amounts actually contributed to a trust since the effective date of the standards results in a liability (or asset). GASB 45 does not require a government to contribute to a trust, but governments must report the difference between the PAYGO and the ARC on its financial statements.

Smaller governments and government who have insured benefits or defined contribution plans have different reporting requirements. Governments with fewer than 100 participants may estimate the AAL and the ARC using simplified methods and assumptions. Governments that participate in defined contribution OPEB plans must recognize OPEB expense/expenditures for their required contributions and a liability for unpaid required contributions. GASB also requires certain disclosure of insured benefits, mainly relating to current year premiums paid.

Implicit subsidy

If the government offers OPEB but does not contribute to the cost, the government will not have any OPEB liability. However, the government will have to calculate an OPEB liability, even if the government does not contribute to

the cost, if it gives an implicit rate subsidy. An implicit rate subsidy exists when the actives and retirees pay the same premium. Example: active and retired employees pay a blended community premium of $300 for health insurance and claims experience for the retirees at $350, the implicit rate subsidy equals $50.

Multiple Employer Plans

The GASB Statements apply whether the government issues its own financial reports or whether its financial reports are included in another entity. The reporting requirements differ depending upon whether a government participates in an arrangement covering all employees on a pooled basis (cost sharing multiple employer) or whether the government participates in an arrangement which accounts for plan benefits and assets by entity (agent multiple employer).

In a cost sharing multiple employer plan, the participating government share all costs and perform one actuarial valuation using the same actuarial assumptions. The sponsor of the cost sharing multiple employer plan must disclose all participating employers. A participating employer recognizes its OPEB expense for its contractually required contributions. Disclosures include identification of the methods for determining the contractually required contribution rate (for example, by statute or contract or on an actuarially determined basis).

In an agent multiple employer plan, participating governments each have their own plan and perform their own actuarial valuation. Assets are combined for investment purposes and the plans are administered independently according to its terms.

Effective Dates and Transition

The effective date depends upon a government's total annual revenues in the first fiscal year ending after June 15, 1999. GASB 43 is effective one year earlier than GASB 45. GASB 45 is effective for periods beginning after December 15, 2006 (FY 2008), for phase 1 governments (those with total annual revenues of $100 million or more); after December 15, 2007 (FY 2009), for phase 2 governments (those with total annual revenues of $10 million or more but less than $100 million); and after December 15, 2008 (FY 2010), for phase 3 governments (those with total annual revenues of less than $10 million). Component units have the same time frame.

Funding

As stated above, GASB 45 does not require a state or local government to fund OPEB, but a government who sets aside funds in an irrevocable trust may use a larger discount rate assumption of 8% rather than using the discount rate of investments available (e.g., short term) in determining its liability.

If a government does not fund the liability, it will have a growing net OPEB obligation reported which could have a negative impact on credit ratings and cost of issuing debt.

If a government funds an OPEB plan in a trust, GASB 43, the plan's financial reports requires: (a) plan description (e.g., benefits offered, eligibility and how the government reflects the plan in its financial statements); (b) funded status (e.g., assets v. liabilities); (c) information on the actuarially determined liability for OPEB.

Establish Trust: Types

Because GASB allows a higher discount rate, which lowers liabilities, for assets held in a separate irrevocable trust, many governments will establish trusts. The trust must only provide OPEB to retirees and beneficiaries and have legal protection from creditors.

In order to create a trust, a government must have authority. A government may have express authority to create the trust or may have implied authority through a broad power. The government may create the trust by legislation or through a separate document. Once created, the trustees must have the authority to make investments beyond the short term investments which statutes usually give governments. Often the State legislature must pass legislation giving OPEB trustees this authority.

The three types of funding vehicles often considered for OPEB are: (a) 401(h) account; (b) VEBA; and (c) Internal Revenue Code Section 115 trust.

A 401(h) account is a separate account within a tax qualified pension plan. This separate account provides health benefits for retirees, spouses and dependents and not used for any other purpose. The annual contribution for this portion of the pension plan cannot exceed 25% of the total actual contribution to the pension fund. After the account pays all health liabilities, assets can revert to the employer.

Advantages:

- Establishment relatively simple-a plan amendment
- Trustees invest the assets with pension assets, no new investment policies needed (separate recordkeeping required)
- Same Trustees
- Employee pre-tax contributions permitted (i.e., "pick up contributions")
- After liabilities are paid, assets can revert to employer

Disadvantages:

- Contributions limited based on pension contributions
- Only participants in the plan can receive benefits

A Code Section 115 Trust is exempt from taxation for income it generates because it is an "integral" part of the government or because it serves an "essential government function". Through Private Letter Rulings, the IRS has stated that a trust for funding health benefits meets this requirement.

Advantages:
- No contribution limit
- Flexibility in establishing
- After liabilities are paid, assets can revert to employer

Disadvantages:
- Relatively new funding mechanism with very little IRS guidance
- Unknown whether employee contributions permitted

A Code Section 501(c)(9) (Voluntary Employees' Benefits Association) trust is exempt from taxation because it provides welfare benefits. The membership must control the trust (through representatives). The sponsor must file a Form 1024 for a determination letter from the IRS to recognize its tax exempt status.

Advantages
- VEBAs have long been recognized as a funding mechanism for welfare benefits; IRS guidance exists
- No limit on contributions

Disadvantages
- Employees must make contributions on an after tax basis
- Involvement of employees, because the membership, must "control" the VEBA membership and is independent from employer; employees generally elect/appoint the trustees; trustees can be an independent trustees (e.g., bank) if established through collective bargaining
- The IRS requires a determination letter
- Recordkeeping requirements, must maintain records of contributions and benefits
- Upon termination, the VEBA assets must provide plan benefits or revert to the participants (as ordinary income)

<u>Limiting OPEB Liability</u>

In order to reduce their OPEB liability, many governments may consider plan design changes or may even consider terminating benefits. Examples of plan design changes include (a) retiree cost sharing (e.g., increasing premiums or copayments/coinsurance; (b) eligibility criteria (no dependent coverage, increase

years of service requirements); (c) plan type (e.g., defined contribution); and (d) benefits. Before making any changes, government must consider any legal constraints, such as collective bargaining contracts, constitutional guarantees or other promises made in documents.

Case law reaches various conclusions as to when governments may change retiree health benefits. It's not surprising that courts reach different conclusions due to the factual nature of these cases and the different documents involved. Generally the courts examine what written promises the government has made.

Courts generally hold that the governments must have expressly promised the benefits. In *Davis v. Wilson County*, 70 S.W.3d 724 (Tenn. S.Ct. 2002), although a 1992 resolution established certain eligibility criteria, the County reserved the right to amend the terms, which it subsequently did in 1998. The employees argued that their rights to the benefits vested when they met the 1992 eligibility criteria. The Court disagreed and the Court held that employees do not have a vested right in retiree health care benefits and "clear and express" language must indicate an intent to give vested benefits. Similarly, in *Colorado Springs Fire Fighters Ass'n v. City of Colorado Springs*, 784 P.2d 766 (Colo.S.Ct. 1989) at issue was an ordinance which provided for a certain payment of retiree health insurance costs and a later ordinance which reduced these payments. The Court found that under the City charter the City determined the amount of health benefits annually and therefore the City could change the cost and design annually. The Court applied the presumption that a law does not create a private contractual vested right but creates a policy which the legislature can change. A statute or ordinance will only be a contract when the language and surrounding circumstances indicates intent to create a contractual right.

Some states have constitutional provisions protecting "accrued benefits" but have applied these provisions differently. In *Duncan v. Retired Employees of Alaska, Inc*. 71 P.3d 882 (Ak. S. Ct. 2003), the Court held that health benefits were accrued benefits and subject to the State constitutional prohibition of diminishing or impairing these benefits. However, the State could make reasonable modifications as long as the State offset any disadvantageous changes by beneficial changes. While Michigan has a similar provision regarding "accrued benefits", the Court in *Studier v. Michigan Public School Employees' Retirement Board*, 698 N.W.2d 350 (Mich. S. Ct. 2005) held that the phrase did not include health benefits and the State statute which created the health plan did not create an contractual obligation, but was merely a policy decision and did not require the State to maintain any particular plan or prohibit the State from amending the plan.

In the past, because many governments have found it easier to offer pension and post employment benefits rather than salary increases, union contracts may have promised the benefits. Courts examine the union contracts to determine to what extent the government can change the benefits. In the *Poole v. City of Waterbury*, 831 A.2d 211 (Conn. S. Ct. 2003) the City replaced an indemnity plan with a

managed care plan. The Court held that although the retirees had a vested right to retiree medical benefits under an expired collective bargaining agreement, they did not have a right to a particular type of retiree medical plan under the agreement and the Court would look to see whether the retirees were "reasonably commensurate" with the benefits under the agreement. The Court noted that given the inability to predict health costs the City should not have to "freeze" a particular type of plan in place for a group of retirees. However, the Court in *Roth v. City of Glendale*, 614 N.W.2d 467 (Wis.S.Ct. 2000) took a different approach and treated benefits in a collective bargaining contract as lasting beyond the life of the contract in the absence of language to the contrary. The Court stated a presumption exists that benefits vest unless language of contract provides otherwise.

Governments must examine its documents, such as plan documents, summary plan descriptions and benefit statements, to determine promises made. Usually official plan documents and summary plan descriptions contain the caveat that the government may amend or terminate the benefits at anytime. However, benefit statements or other brochure description are usually more vague and may state that retirees will receive lifetime benefits.

Once a government examines any promise made, it may then begin to implement any changes to reduce future OPEB liability. Many governments for policy reasons may implement more drastic changes on a prospective basis for future employees.

Conclusion

Because GASB 43 and 45 recently became effective, unresolved issues remain. In addition, as governments examine how to reduce liability, more court cases may examine and determine what promises relating to retiree health care governments have made and to what extent government can change the promises.