To Tell the Truth: How Much in Benefits Are Governments Promising Retirees?

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Local governments often attract workers by offering strong benefit packages. Although the salaries and the wages that local governments offer are sometimes less competitive than those that many private employers offer, the benefit packages for the employees, as well as the retirees, are often relatively lucrative. For retirees specifically, pensions are the most common benefit provided, but other postemployment benefits (OPEB), such as health insurance and life insurance, have become increasingly prevalent over the years.

Obviously, the provision of OPEB comes with a price tag. Recent changes in generally accepted accounting principles require that, over the next few years, local governments offering OPEB begin to identify and report the value of these benefits in their financial statements. The question being posed is simple: Just how large in dollar amounts are city and county governments' promises to their retirees?

Some North Carolina cities and counties may characterize this new requirement as the dropping of the other shoe. The first shoe dropped in the mid-1990s, when the Governmental Accounting Standards Board (GASB) issued guidance requiring state and local governments to identify what pension benefits they were promising to their employees and how much they should fund their pension plans currently to make those plans capable of providing the benefits being promised in the future.

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* applies a similar requirement to state and local governments that offer some type of OPEB. This article provides answers to local officials' basic but important questions about the new GASB accounting and reporting requirements, and dispels some incorrect interpretations or assumptions. It does not examine technical matters related to OPEB, such as calculation methods, actuarial assumptions, and the finer details of the accounting and financial reporting requirements, but it does identify some resources for further study (see the sidebar on this page). A later article may focus on how North Carolina local governments are implementing the new reporting standards, and describe the variety of valuations that are being calculated statewide.

OPEB Defined

Many cities and counties in North Carolina offer OPEB to their employees and retirees (for common benefits, see the sidebar on page 16). At present, governments tend to pay for OPEB on a pay-as-you-go basis. With health insurance, for example, some governments pay premiums for retirees from the date of their retirement until they are eligible for Medicare. Some also pay for Medicare supplemental policies, which extend the benefits for decades more. The premiums may be substantial, yet governments may have only a handful of retirees drawing the benefits at any given time. This circumstance allows governments to handle such funding within their annual budgets, thus paying as they go.

Currently, the cost may be relatively immaterial when compared with the costs of overall payrolls and employee benefits. However, an easily forgotten component of OPEB programs is the cost of the promises. In all likelihood, the number of retirees who will be eligible for OPEB will grow, especially as the baby boomers reach retirement

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Additional Resources

Gauthier, Stephen J. *Employer's Accounting for Pensions and Other Post-Employment Benefits (OPEB).* Chicago: Government Finance Officers Association, 2005.

Governmental Accounting Standards Board. Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments.* Norwalk, CT: Governmental Accounting Standards Board, 1999.

Governmental Accounting Standards Board. Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.* Norwalk, CT: Governmental Accounting Standards Board, 2004.

North Carolina Association of County Commissioners, www.ncacc.org.

North Carolina League of Municipalities, www.nclm.org.

age in ever-increasing numbers. The premiums will almost assuredly grow as well, but at what rate? Governments may be able to handle the costs of the premiums on a pay-as-you-go basis now, but will they be able to do so in ten years? Further, with every employee who becomes "vested" in a plan (that is, who is granted a right to the government's contribution in his or her name), governments incur a liability. Even if governments modify OPEB plans to rein in costs, there still will be liabilities for those already vested.[1]

General Overview of the New Requirements

What do the new requirements really mean for cities and counties?

In many cases, the answer to this question may shock managers, elected officials, and the public. Asking "How much is this program going to cost in the long run?" is certainly fair, but governments have typically not been required to answer it. Nor have they voluntarily assessed the long-term cost of the obligations that they have undertaken. Governments have traditionally focused only on how much they spend, with an emphasis on the present.

Which cities and counties will be required to implement the new OPEB accounting and financial reporting requirements?

Basically, any local government that provides postemployment benefits for retirees other than general pension benefits will be required to identify and report the costs and the liabilities associated with these benefits.

What kinds of arrangements are considered OPEB?

Obviously, a government provides OPEB if it subsidizes or simply supplements benefits like health insurance and life insurance for retirees. However, a government may be providing OPEB even if it is not directly paying for any of the coverage. Suppose, for example, that a government does not pay for retirees' health insurance premiums, but it has negotiated with its health insurance carrier to allow retirees to purchase coverage at the same group rates that the government pays for active employees. This government is providing OPEB as defined by the GASB standards. Even though the government may not be directly paying the premiums on behalf of the retirees, it is indirectly subsidizing the retirees' rate. Otherwise, insurers would be charging a higher group rate overall because the retirees, carrying greater risk, have changed the group's demographic makeup. This indirect support is known as an "implicit rate subsidy," the value of which is considered to be OPEB. Thus the accounting and reporting standards of GASB Statement No. 45 apply.

What is the required date for implementation of the standards?

The short answer is simple: cities and counties in North Carolina that offer OPEB must implement the standards in fiscal year 2007–8, fiscal year 2008–9, or fiscal year 2009–10, depending on the size of their OPEB plan membership.

The GASB defines "plan membership" to include active retirees and their eligible dependents, active employees who are vesting in the plan, and terminated employees who have vested benefits but are not yet eligible to receive them. The GASB is requiring the largest governments (termed Phase 1 governments) to implement the OPEB provisions first, the medium-sized governments (termed Phase 2 governments) next, and the smallest governments (termed Phase 3 governments) last.

Specifically, for North Carolina governments, the timeline for required implementation is related to the phase a government was considered to be in when it implemented the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* several years ago, as follows:

- Phase 1 governments (about 80): the fiscal year ending June 30, 2008
- Phase 2 governments (about 320): the fiscal year ending June 30, 2009
- Phase 3 governments (about 770): the fiscal year ending June 30, 2010

The GASB not only allows early implementation of the standards but encourages it. By contrast, the North Carolina Local Government Commission does not require early implementation, so few governments plan to implement the standards before the specified dates.

This timeline relates to when the external financial statements will be affected for governments that have OPEB programs. As is briefly addressed later in this article, the budgetary implications of the new guidance will differ depending on the choices local governments make concerning pay-as-you-go versus advance-funding policies for their OPEB plans.

Common Other Postemployment Benefits

Tier 1

Medical insurance
Medicare supplemental insurance
Dental insurance
Vision insurance
Hearing insurance

Tier 2

Life insurance
Disability insurance
Long-term care insurance

How is the value of the promised benefits to be calculated?

The value of the promised benefits must be determined by an "actuarial valuation," the process by which a professional actuary, using plan demographic formulas and assumptions sanctioned by generally accepted accounting principles, calculates the present value of promised plan benefits to eventual beneficiaries, and allocates the costs to relevant periods. The valuation is performed periodically on a predetermined schedule. As variables change, so do the results. An actuarial valuation ultimately provides information to employers about the cost of their plans for a specific period, the value of the overall liability being promised to the plan membership, and the annual contributions to the plan that are necessary for the plan to be considered adequately funded.[2]

How often are actuarial valuations required of governments that offer OPEB?

The size of the plan determines the schedule for required actuarial valuations. Basically, the larger the plan, the more frequent the actuarial valuations.

- Plan membership (as previously defined) of 200 or more: every two years.
- Plan membership from 100 to 200: every three years.
- Plan membership of less than 100: not required but encouraged; for plans for which actuarial services are not procured, governments will calculate estimates of cost and liabilities in-house using formulas provided by the GASB.

The North Carolina League of Municipalities and the North Carolina Association of County Commissioners have negotiated an agreement with an actuarial firm to provide actuarial valuations at group rates for any cities and counties that want to participate. However, cities and counties have the option of procuring actuarial studies independently.

Budgetary and External Reporting Ramifications of the New Requirements

Will governments that currently provide OPEB on a pay-as-you-go basis be forced to fund the plans per the results of the actuarial valuation?

Absolutely not. For example, typically the only budgetary effect of a pay-as-you-go policy for OPEB on a government's general fund is the reporting of an expenditure for the amount of OPEB actually being provided. If a government chooses to continue a pay-as-you-go approach, and it certainly may do so, the general fund still will reflect only an expenditure for the amount of the OPEB being spent. However, if a government chooses to advance-fund an OPEB plan on the basis of the actuarial valuation, the general fund will reflect an expenditure for the amount actually paid to the plan, via an irrevocable trust or a similar arrangement.

Managing OPEB expenditures is likely to become more important over the mid to long term, so governments should consider OPEB in forecasting their revenues and expenditures. For more on financial forecasting, see the article by William J. Rivenbark on page 6 of this issue.

If a government is not required to advance-fund OPEB plans, what are the reporting implications of the required actuarial valuations?

As noted earlier, governments were recently required to implement a new model of external reporting per the provisions of GASB Statement No. 34. In addition to having to report fund

financial statements, governments now must report government-wide financial statements. The general fund basically gives a "collection and spending," or financial, perspective on operations. The government-wide financial statements give an economic perspective. That is, they report current expenses and both current and long-term liabilities.[3]

Thus the general fund will report as an expenditure only an amount actually paid during the year for OPEB (either the benefits paid by the government or the amount contributed to the plan, based on the actuarial valuation). However, the government-wide financial statements will report the annual required contribution, as calculated by the actuary, as an expense and a liability that generally reflects the amount of the actuarially determined contribution that a government chooses *not* to fund. *A liability will not be reported in the government-wide financial statements if a government chooses to advance-fund its OPEB plan on the basis of the actuarial calculations.*

What are the mechanics of advance-funding an OPEB plan?

Although the new OPEB reporting requirements do not require governments to change their pay-as-you-go policies related to OPEB, the GASB certainly hopes that governments will choose to adhere to the actuary's recommendations to set certain levels of funds aside in order to provide adequate benefits both currently and in the future. The standards require that the funds be placed in a trust arrangement "that is capable of building plan assets that are separate from, and independent of the control or creditors of, the employer(s) and that are dedicated to the sole purpose of providing benefits."[4] In other words, once funds are placed in such an arrangement, they cannot be accessed and used for anything else.[5] Again, though, if a government chooses to advance-fund on the basis of the actuarial valuation, a liability will not be reported in the government-wide financial statements.

Governments that now provide OPEB on a pay-as-you-go basis will not be forced to fund their plans per the results of their actuarial valuations.

What are the implications of remaining on a pay-as-you-go basis?

To reiterate, the new standards do not require governments to change their pay-as-you-go policies for providing OPEB. But there are external-reporting implications of the actuarial valuations in the government-wide financial statements and the note disclosures. Governments now have to report what the value of the benefits being promised to employees and retirees is and whether or not they are setting aside funds to provide benefits in future years. Thus, rating analysts, creditors, and other users of the financial statements will have more information to evaluate the overall financial condition of the governments.

For example, if an actuarial valuation indicates that the value of promised benefits far exceeds the amount of funds being set aside for those payouts, the wisdom of not advance-funding these plans may be questioned. Eventually, these implications could adversely affect credit ratings and creditors' assessments of a government's overall economic condition.

Conclusion

Governments are just beginning to grapple with the potential implications of these new accounting and reporting standards. Several of the largest jurisdictions in North Carolina have had actuarial valuations performed on their OPEB plans, but the majority of the state's cities and counties are only beginning to evaluate the standards' applicability to them.

As more and more governments procure actuarial valuations, elected officials and management will have to determine what to do next. Should they change their policies from pay-as-you-go to advance funding? Will they be able to keep the plan provisions that are in place, or are the future costs too prohibitive? Will bond ratings be affected?

Eventually, the results of the actuarial valuations will become widely known, and government officials all across the state will be interested in the funding changes, policy modifications, and the like that others may be considering. Over the next several fiscal periods, governments that provide OPEB will have to determine what this newfound information actually means and how they should use it.

Notes

1. Governments may modify their OPEB plan provisions if they deem those provisions to be too expensive or costly in the long run, but they must consider the legal and practical implications of such modifications. Typically, governments may modify plan provisions for personnel not yet vested in the plan, but personnel already vested most often will have continuing legal claims. Further, there is a very fine line between fiscal prudence, and compensation and benefit policies that may affect employee retention and recruitment successes.

2. In most authoritative literature, this contribution is officially known as the "annual required contribution."

3. For further information and for clarification of specific financial statement content and formats, *see* "How to Read Governmental Financial Statements, Part 2," by Gregory S. Allison, *Popular Government,* Fall 2001, pp. 24–31.

4. Governmental Accounting Standards Board, *Guide to Implementation of GASB Statements 43 and 45 on Other Post-employment Benefits, Questions and Answers* (Norwalk: CT: GASB, 2005), 32.

5. GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans,* provides accounting and finanical reporting requirements for funds that have been established. Thus, although GASB Statement No. 45, the focus of this article, affects all governments that provide OPEB, GASB Statement No. 43 applies only to governments that formally establish trust arrangements to advance-fund OPEB.