Memorandum

GASAC Meeting

February 21–22, 2013

To: GASAC Members

From: Scott Reeser, Roberta Reese, Michelle Czerkawski, and Erin Bojarzin

C: Board Members, David Bean, GASB Technical Staff, and Meeting Observers

Date: January 28, 2013

Re: Other Postemployment Benefits Project

INTRODUCTION

This paper summarizes the major tentative decisions made by the Board regarding the Other Postemployment Benefits (OPEB) project since the November 2012 Governmental Accounting Standards Advisory Council (GASAC) meeting. In addition, this paper addresses (1) which attribution method should be used for an OPEB measurement and (2) the reliability of the liability measurement, topics the Board will discuss at its February 2013 meeting. The purpose of this paper is to seek GASAC member feedback on these major tentative decisions, attribution method, and the reliability of the liability measurement.

The measurement of a pension or OPEB liability essentially involves three steps:

1. *Projecting* future benefit payments based on the terms of the plan and assumptions about relevant factors that affect the amount of the payments
2. *Discounting* the projected benefit payments to their present value
3. *Attributing* the present value of projected benefit payments to past and future periods of employee service.

This paper raises issues related to all three steps: certain factors to be considered in the projections (projecting) other than those discussed at the November 2012 GASAC meeting; the discount rate (discounting); and the cost allocation method (attributing).

PROJECTING OPEB PAYMENTS THAT ARE DETERMINED ON A BASIS SIMILAR TO PENSIONS

In its initial discussions on the projection of benefits for the measurement of OPEB, the Board's discussion focused on OPEB that are provided through a defined benefit arrangement in which the level of benefits generally are the same among all retirees. In some OPEB arrangements, however, benefits are determined similar to pensions. That is, the benefit formula is based on either an employee's salary at the time employment ends or the service credits that have been earned by the employee, or both. For example, an employer may pay 5 percent per year of service of an eligible retiree's health insurance premium, or may make a monthly payment into a heath savings account of 1 percent of an eligible retiree's ending monthly salary. In both of these examples, the substantive plan as understood by the governmental employer and plan members includes the effects of projected salary changes and projected service credits. There may be other examples of arrangements that exist that also incorporate automatic postemployment benefit changes or projected ad hoc postemployment benefit changes.

The Board believes that when OPEB is determined based on formulas that include the effects of (a) automatic postemployment benefit changes, (b) ad hoc postemployment benefit adjustments, to the extent that they are substantively automatic, (c) projected salary changes, or (d) projected service credits, the projection of OPEB should include these effects.

In Statement No. 68, *Accounting and Financial Reporting for Pensions,* the Board concluded that, to the extent that net resources have been accumulated in a qualified trust, the employer can avoid the sacrifice of additional resources associated with the total pension obligation. That is, the contribution of resources and earnings on those resources in the qualified trust are the primary resources relied upon for the payment of benefits and, once resources are contributed to a qualified trust, the employer no longer has primary responsibility for payment of the benefits. Instead, the employer has a secondary responsibility for payment of those benefits to the extent resources are held in a qualified trust. The Board concluded that this obligation would meet the definition of a liability only when it is probable that the employer would have to sacrifice additional resources because earnings on the contributions prove to be insufficient or estimates of benefits to be paid prove to be understated. However, for the amount of actuarial present value of projected benefits for which resources have *not* been accumulated in the trust, the employer would recognize a liability as the employer is responsible to make future contributions of resources to the plan for that portion of the benefit payments.

The Board also discussed circumstances in which accumulated sick leave balances are used to provide or enhance the amount of service credit that is used to determine an employee's defined benefit pension or OPEB. Current accounting and financial reporting contained in footnote 6 of Statement No. 16, *Accounting for Compensated Absences* (as amended by Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and Statement 68), states that the impact of the additional service time for OPEB purposes is required to be included in the projected future service of an employee for purposes of measuring OPEB both (1) when service credits are used in determining an employee's probable eligibility for benefits and (2) in the projection of benefit levels in circumstances in which the OPEB formula incorporates years of service. By including these benefits in the projection of future benefit payments along with other OPEB payments, the discounting of OPEB payments in a plan and the allocation to current and future periods of these payments is done for all of the benefits that will be paid through the OPEB arrangement.

The Board tentatively decided that the enhancements of service credits, when unused accrued sick leave are used in the determination of service credits, should be included in the projection of benefits for the measurement of an employer's OPEB. The Board believes that the use of these earned benefits to enhance a service credit for OPEB is another assumption that should be made in the projection of the benefits that ultimately will be paid as part of the OPEB arrangement.

DISCUSSION QUESTION

1. **Should the projection of benefits for the measurement of an employer's OPEB liability include:**

    a. **Automatic postemployment benefit changes, ad hoc postemployment benefit changes to the extent they are considered to be substantively automatic, projected salary changes, and projected service credits when the effects of these future events impact the benefit formula? Why or why not?**

    b. **Enhancements of services credits when unused accrued sick leave are used in the determination of service credits? Why or why not?**

PROJECTING TAXES ON OPEB PROVIDED

The Patient Protection and Affordable Care Act (Public Law 111-148), as amended by the Health-Related Portions of the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152), establishes an excise tax, beginning for calendar year 2018, on employer-provided health insurance benefits that are determined to be an "excess benefit." The excise tax is to be determined monthly on the amounts in excess of a defined threshold, with the sum of the monthly excess benefit amounts for a taxable year taxed at 40 percent.[1]

The excise tax with respect to an employee is required to be paid by the coverage provider, the definition of which depends on the arrangement in which the health insurance benefits are

[1] The annual excess benefit threshold in 2018 for self-only coverage is $10,200 multiplied by a health cost adjustment percentage. For other-than-self-only coverage, the 2018 excess benefit threshold is $27,500 multiplied by a health cost adjustment percentage. The health cost adjustment percentage is defined as 100 percent plus the excess, if any, of the percentage by which the per-employee cost of providing coverage under the Blue Cross/Blue Shield standard benefit option under the Federal Employees Health Benefits Plan for plan year 2018 exceeds such cost for plan year 2010 over 55 percent. For years subsequent to 2018, the excess benefit amounts will increase by a cost-of-living adjustment (COLA) equal to the COLA in the tax tables so that inflation does not result in tax increases. In addition, the COLA for 2019 will be increased by an additional 1 percentage point. The initial 2018 threshold for qualified retirees or for individuals who participate in a plan in which the majority of the members covered are engaged in a high-risk profession or employed to repair or install electrical or telecommunication is $1,650 higher for self-only coverage and is $3,450 higher for other-than-self-only coverage. A qualified retiree is an individual who is receiving coverage by reason of being a retiree, has attained age 55, and is not entitled to benefits or eligible for enrollment in Medicare. High-risk professions are limited to law enforcement officers, fire protection activities, providing out-of-hospital emergency medical care, and individuals engaged in the construction, mining, agriculture (not including food processing), forestry, and fishing industries.

provided. In circumstances in which employer-sponsored health insurance coverage is provided under a group health plan, the health insurance issuer (the insurance company) is required to pay the excise tax. In circumstances in which the employer-sponsored health insurance coverage consists of contributions to a health savings account or a medical savings account, the employer is required to pay the excise tax. In all other circumstances, the entity that administers the plan benefits is required to pay the excise tax.

The Board considered the view that the amount of benefits payable in the future should include all costs to the employer of providing those benefits, including the excise tax, so that all such amounts are included in a government's cost of service in the period(s) in which the benefit recipient provided services to the government. This would be similar to the current accounting and financial reporting guidance for state and local governments related to accrued compensated absences. Paragraph 11 of Statement 16 requires salary-related payments associated with the payments of compensated absences to be accrued as an additional liability, including amounts for vacation leave and other compensated absences with similar characteristics that are expected to be used as paid time off. This additional liability is to be calculated using the rates in effect at the reporting date. Included within this liability are the employer's share of Social Security and Medicare taxes and the employer's contributions to a defined contribution pension plan or a cost-sharing multiple-employer defined benefit pension plan when compensated absence amounts are included in the salary base on which contributions are made to the plans. Paragraph 47 in the Basis for Conclusions of Statement 16 states that the "Board believes a governmental entity's liability for these payments arises at the same time that the employee earns the right to the associated compensated absences."

The Board also considered the view that the assessment of the excise tax for providing excess health insurance benefits is a transaction resulting from the payment of the healthcare benefit. This view would include only actual benefit payments in the projection of OPEB—the excise tax would not be included in the projection of benefits for OPEB measurement. The Board tentatively decided that taxes related to the level of OPEB provided by an employer should be included in the projection of benefits for the measurement of an OPEB liability. The Board believes that, similar to salary-related payments associated with the payments of compensated absences, a government that offers a level of benefits subject to a tax has incurred a liability at the time that the employee earns the benefits, rather than at the time the government makes final payment on the deferred portion of those benefits. In addition, the Board believes that unlike the reimbursement provisions of Medicare Part D—which are a promise of payments from another government that is not legally obligated for the benefits provided as a result of the exchange transaction between the employer and the employee—an employer that is subject to an OPEB-related tax has incurred an obligation at the time of the employment-exchange transaction because the employer has received the underlying services for which a portion of the compensation is subject to the tax.

The Board also believes the rates used for determining the effect of these taxes should be the rates that are in effect or approved by the assessing government to be used in future periods when the tax is assessed. That is, the rates that have been enacted are the best estimate of the tax rate that ultimately will be paid until the rates are actually changed by the assessing government—the federal government.

DISCUSSION QUESTION

2. **Should projected taxes or other assessments on providing OPEB be included in the projection of benefits for the measurement of a government's OPEB liability? Why or why not?**

DISCOUNT RATE FOR OPEB LIABILITY MEASUREMENT

At its January 2013 meeting, the Board discussed issues related to the discount rate used to calculate the present value of OPEB in the measurement of an OPEB liability. Because the Board has tentatively decided that an employer's net obligation for OPEB meets the definition of a liability, when determined by using the overall approach required by Statement 68, the Board considered the approach used in Statement 68 taking into account the following significant differences between pensions and OPEB:

1. Ability to modify benefits
2. OPEB may be provide implicitly
3. Legal authorization of benefits
4. Funding of benefits.

The ability to change benefits, the implicit nature of some OPEB arrangements, and legal authorization of the benefits are, to some extent, interrelated in explaining why changes in projected OPEB may occur. From the employee's perspective, this ability to change benefits is similar to credit risk—the risk that the employer will not fulfill its obligation for the expected transaction. The other difference listed above, the funding of the benefits, is seen through the high percentage of pay-as-you-go OPEB funding arrangements (as found in the research of comprehensive annual financial reports that the project staff performed at the beginning of this project). Without assets being accumulated in a trust, resources used to pay OPEB would not come from resources invested using a long-term investment strategy, which is integral to determining the discount rate for pensions under Statement 68.

The Board tentatively decided that the determination of a discount rate for the measurement of an OPEB liability should be the same as the Board required Statements 67 and 68 for pensions. That is, the discount rate should be a single rate reflecting:

1. The long-term expected rate of return on plan investments that are expected to be used to finance the payment of OPEB, to the extent that:
   a. The plan's fiduciary net position is projected to be sufficient to make projected benefit payments and
   b. Plan assets are expected to be invested using a strategy to achieve that return
2. A yield or index rate for 20-year, tax-exempt general obligation municipal bonds with an average rating of AA/Aa or higher (or equivalent quality on another rating scale), to the extent the conditions in 1.a. and 1.b. are not met.

The Board believes that similar liabilities of an employer (such as pension and OPEB both being deferred compensation resulting from the employment exchange transaction) should be recognized and measured in a similar manner. With the exception of the ability of an employer to modify benefits, the Board does not believe that the nature of the OPEB obligation is substantively different from the nature of a pension obligation, even though many OPEB arrangements do not have assets set aside in trust to make benefit payments as they come due.

DISCUSSION QUESTION

3. Should the discount rate used in the measurement of an OPEB liability be calculated using the same process as in Statement 68? Why or why not?

ATTRIBUTION METHOD FOR OPEB LIABILITY MEASUREMENT

At its February 2013 meeting, the Board will discuss the actuarial cost method(s) to be applied in the measurement of an OPEB liability. The choice of an actuarial cost method affects the pattern of attributing the actuarial present value of projected benefit payments to periods of employee service. There are two classes of attribution approaches: benefit-allocation approaches and cost-allocation approaches. Although each class is related, methods in each class have distinct features that impact the periods to which the actuarial present value of projected benefits are allocated.

Paragraph 13d of Statement 45 requires one of six actuarial cost methods be applied in an actuarial valuation for accounting and financial reporting purposes. The six acceptable methods are:

- Entry age
- Frozen entry age
- Attained age
- Frozen attained age
- Projected unit credit
- Aggregate.

Entry age, frozen entry age, attained age, frozen attained age, and the aggregate method are cost-allocation approaches, while projected unit credit is a benefit-allocation approach. Paragraph 13 of Statement 45 further requires that "actuarial methods and assumptions applied for financial reporting should be the same methods and assumptions applied in determining the plan's funding requirements, unless compliance with this paragraph requires the use of different methods or assumptions."

The most recent guidance regarding the attribution of the actuarial present value of projected benefits for pensions is in paragraph 32, for single and agent employers, and paragraph 70, for cost-sharing employers, of Statement 68. Those paragraphs require that the entry age actuarial cost method be used:

> The **entry age actuarial cost method** should be used to attribute the actuarial present value of projected benefit payments of each employee to periods in conformity with the following:
>
> a. Attribution should be made on an individual employee-by-employee basis.
> b. Each employee's service costs should be level as a percentage of that employee's projected pay. For purposes of this calculation, if an employee does not have projected pay, the projected inflation rate should be used in place of the projected rate of change in salary.
> c. The beginning of the attribution period should be the first period in which the employee's service accrues pensions under the benefit terms, notwithstanding vesting or other similar terms.
> d. The service costs of all pensions should be attributed through all assumed exit ages, through retirement. In pension plans in which the benefit terms include a **deferred retirement option program (DROP),** for purposes of this Statement, the date of entry into the DROP should be considered to be the employee's retirement date.
> e. Each employee's service costs should be determined based on the same benefit terms reflected in that employee's actuarial present value of projected benefit payments.

In selecting the entry age actuarial cost method to be required to be used for pension measurements, the Board determined that two principal criteria should be used in the attribution of costs to periods: (1) portions of the actuarial present value of benefit payments should be assigned to past periods to the extent that benefits relate to services received from employees in those past periods; and (2) the actuarial present value of projected benefit payments should be assigned to past, current, and future periods using the same approach. Although both the entry age and the projected unit credit actuarial cost methods met these criteria, the Board determined that a portion of any incremental value explicitly associated with future exchanges of service under the benefit terms implicitly is associated with past periods of service, and the manner in which the entry age actuarial cost method attributes these amounts equally among all periods is more representational of the employment exchange over the employee's career.

Many OPEB arrangements, notably retiree healthcare benefits, are provided to employees based on different criteria than pensions. Pensions generally vary among recipients as they are often paid based on formulas considering years of service and earnings at or near retirement. On the other hand, retiree healthcare benefits generally are the same for all eligible recipients. Some may consider this "all or nothing" aspect related to OPEB as requiring a different approach to attributing the actuarial present value of projected benefits to periods. On the other hand, some may consider an approach that attributes these amounts equally among all periods over the employee's career to be more representational of the employment exchange.

DISCUSSION QUESTIONS

4. **Do you generally favor (a) allowing a choice among six actuarial cost methods or (b) reducing the number of options? Why?**

5. **If you favor reducing the number of options, what method(s) do you believe should be allowed? Why?**

RELIABILITY OF AN OPEB LIABILTY MEASUREMENT

At its February 2013 meeting, the Board also will discuss the reliability of the measurement of an OPEB liability. One of the qualitative characteristics of financial information communicated in financial statements is reliability of the information. According to Concepts Statement No. 1, *Objectives of Financial Reporting*, the criteria for what is considered reliable are not absolute. Paragraph 64 describes the characteristics of reliability as follows:

> Financial reporting should be reliable; that is, the information presented should be verifiable and free from bias and should faithfully represent what it purports to represent. To be reliable, financial reporting needs to be comprehensive. Nothing material should be omitted from the information necessary to faithfully represent the underlying events and conditions, nor should anything be included that would cause the information to be misleading. *Reliability does not imply precision or certainty*. Reliability is affected by the degree of estimation in the measurement process and by uncertainties inherent in what is being measured; financial reporting may need to include narrative explanations about the underlying assumptions and uncertainties inherent in this process. *Under certain circumstances some financial information is based on reasonable estimates. A properly explained estimate provides more meaningful information than no estimate at all.* [Emphasis added]

The measurement of a net OPEB liability, when using the overall measurement approach in Statement 68, would be similar to the existing measurement of the net OPEB obligation in accordance with Statement 45. Both approaches to measuring the net obligation are based upon a number of estimates and assumptions about economic and demographic factors that influence future events (and, in some cases, the same estimates and assumptions), and both employ actuarial methods to determine reported measures. Although the assumptions made in measuring the net OPEB liability might vary from actual events, that fact alone is not sufficient to consider the estimates based on those assumptions to be unreliable. Provided that the estimates and assumptions used in determining the net OPEB liability are not selected with a desired outcome in mind (that is, they are free from bias), it could be concluded that the estimate is a faithful representation, is comprehensive, and is not misleading, even if the actual result may be different from the estimate.

In deliberations that led to Statement 45, some respondents raised arguments generally related to differences between governmental employers' commitments to provide OPEB to support their views on (1) whether a long-term liability for OPEB exists, and (2) if an OPEB liability exists, whether it is sufficiently measureable to report in financial statements. These arguments, included with other objections to accounting issues in Statement 45, are summarized as follows from paragraph 73 in the Basis for Conclusions of Statement 45:

1. OPEB that is not guaranteed or vested is contingent on periodic authorization by the employer, which often stipulates its right to modify or discontinue benefits.
2. The amounts of future OPEB payments are affected by a number of demographic and economic variables, including the healthcare trend rate, that make them inherently difficult to estimate.

DISCUSSION QUESTION

6. Is a measurement of a net OPEB obligation sufficiently reliable to be recognized as a liability in financial statements? Why or why not?