GASB 43 and 45 Requirements Present Formidable Challenges

by Harvey Katz

Most states and local governments are aware that the Governmental Accounting Standards Board (GASB) in its Statement No. 43 and Statement No. 45 will require that balance sheets reflect actuarially determined liabilities for other post-employment benefits (OPEB), but most governments have not yet begun to plan to comply with the requirements of GASB 43 and 45. Most employers do not yet fully understand the significant changes that they must face with respect to the implementation of these two rules. The experience of the private sector with similar requirements shows that major changes will be needed in the way OPEB are structured, funded, and provided.

Most government managers are aware that OPEB are typically reported on a sponsor's financial statements on a pay-as-you-go basis, and it is rare for a government employer to report the actuarial cost of these benefits or to establish reserves of any kind. Beginning in fiscal year 2007, GASB 45 changes this practice. GASB 45 requires that such benefits be reported in a manner similar to current requirements for the private sector.

The effective date for compliance with GASB 45 depends on the size of the revenue in each government's 2000 fiscal year. Phase 1 includes organizations with revenues in excess of $100 million; phase 2 includes entities with revenues of $10 million or more but less than or equal to $100 million; and phase 3 applies

to governments with revenues of less than $10 million.

Phase 1 employers must comply for reporting periods after December 15, 2006; phase 2 employers must comply for reporting periods after December 15, 2007; and phase 3 employers must comply beginning December 15, 2008. Reporting for GASB 43, relating to any dedicated OPEB trust accounts, commences one year earlier in each category.

As a result of these requirements, government employers need to immediately focus on several key issues. Undoubtedly many will be surprised—even shocked—by the magnitude of the liability. It has been estimated that, on average, OPEB liabilities will increase by a factor of 7–8 times of current pay-as-you-go costs. Clearly, the existence of a large liability will adversely impact most governments' credit ratings and associated ability to issue debt.

Note that GASB 43 and 45 do not require government employers to do anything other than report OPEB liabilities in a different manner. However, it is the anticipated effect of reporting these dramatically higher costs that will motivate efforts to control those costs.

HOW TO APPROACH GASB 43 AND 45

The first concern of any government employer should be to take any appropriate action that reduces the impact of this newly created balance sheet liability.

Trust accounts. The most obvious first step is the establishment of a separate trust account for OPEB liabilities. Establishment of a dedicated trust account will reduce OPEB liabilities by approximately half of those without a trust because actuaries will be able to assume that trust assets and associated earnings will be available to pay benefits. Any trust account established, however, must require funds to be used exclusively for OPEB liabilities and prohibit invasion for other purposes by the sponsoring employer or its creditors.

The trust should also be designed to meet certain other requirements so that its earnings will be exempt from tax under the federal Internal Revenue Code. Government entities have a choice among three different types of trusts:

- Voluntary employees benefit association under section 501(c)(9) of the code.
- Retiree medical benefit account under section 401(h) of the code.
- Governmental activities trust under section 115 of the code.

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Each design has advantages and disadvantages, depending on the type of benefits offered, whether multiple trusts are used, and the manner in which trust assets are invested. The specifics of these requirements are beyond the scope of this article, but it is imperative that any government employer focus the needs and requirements of its particular program to determine the appropriate trust design.

Several professional advisers have suggested that a trust arrangement is not necessary. Technically, an actuary may assume that the assets of any dedicated fund will be available to pay future OPEB as long as the following three requirements are met:

- Funds are dedicated exclusively to payment of OPEB.
- Funds may not be returned to the sponsoring employer.
- Funds are protected from attachment by creditors of the government and the participant.

If these results can be achieved through a non-trust vehicle, plan sponsors also need to address the federal tax consequences of their funding vehicle. Separate funding arrangements do not necessarily enjoy exemption from federal tax on investment earnings and appreciation simply because they have been established by a state or local government. Failure to structure the funding vehicle in a manner that qualifies for federal tax exemption may result in adverse tax consequences and higher plan costs because actuaries may be required to assume that some portion of the plan assets will be used for payment of federal taxes.

Levels of benefits. The foregoing decision is intertwined, in some respects, with the employer's decision regarding other aspects of the plan, particularly whether one or multiple trust funds will be established for different groups of individuals. Typical government employers have different levels of benefits for different classes of employees—police officers, firefighters, teachers, judges, and other municipal employees. It is also common for different levels of benefits to be available to employees who meet various criteria based on age, service, time of participation, and other factors.

The expected magnitude of OPEB liabilities will lead most employers to ascertain costs for each specific employee group. Such information will help determine the source of the liabilities for purposes of future collective bargaining. For example, it is

anticipated that costs for police and fire personnel will exceed those for other groups because of lower retirement ages typical for those groups. It may also be preferable to separately fund each group to avoid unintended subsidization of the benefit costs for one group by another group.

GASB 45 reporting requirements will undoubtedly precipitate efforts to limit the size and scope of the benefits provided. As noted above, most OPEB are mandated by collective bargaining, by state statutes, or by both. Specific information about costs for each employee group will enable employers engaged in collective bargaining to target the most effective cost-cutting methods.

In the case of retirement benefits, it is customary to spell out exact benefit levels in a formal plan document; however, practices with respect to OPEB are much less formal. Nevertheless, GASB 45 requires that estimates of future benefit payments must be based on the employer's and employees' "shared understanding" of the terms of the plan. GASB 45 uses the term "shared understanding" to make it clear that employers must report the cost of informal and/or unwritten programs available, based on the benefit levels agreed to by the government employer and the employees who are receiving the benefits.

Actuaries and accountants whose professional reputations and licenses are at stake may be unwilling to rely on informal understandings, however; thus, they may require more formal documentation of the levels and types of benefits provided. At minimum, to the extent that there are any ambiguities in the shared understanding, actuaries will undoubtedly take the most conservative approach by assuming the highest possible level of benefits. Accordingly, employers will likely need to prepare document—a formal written plan—setting forth the shared understanding of plan terms and provisions.

Medicare and cost reduction. One obvious and relatively painless way to reduce plan costs and benefits is to integrate benefits with those available under Medicare. It is surprising that some OPEB structures do not require participants to seek reimbursement from Medicare as their primary coverage. Although this provision may require participants to complete more paperwork, total benefits available will not be affected. In addition, prescription drug benefits should be reviewed to ascertain whether those benefits qualify for the available subsidy under Part D of the Medicare laws. To qualify, an actuary must certify that the prescription benefit is at least as valuable as the prescription benefit provided under Part D of Medicare, and an application must be filed with the U.S. Department of Health and Human Services.

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If the prescription drug benefit narrowly misses qualifying for the subsidy, the local government should consider increasing the benefit in order to qualify because the value of the subsidy may exceed the cost of a modest increase in the level of plan prescription benefits. If a large increase in benefits would be required to qualify for the subsidy, however, it would be preferable to reduce benefits to a level that would supplement the benefits available under Medicare.

Bonds. Employers may also want to consider whether it is appropriate to finance some of their OPEB liabilities through issuance of taxable or tax-exempt bonds. Financing OPEB liabilities in this manner has certain advantages. The most compelling reason to do so is a potentially positive spread between the government's cost of borrowing and the investment return that can be achieved on the assets held by the OPEB trust. Possible structures include issuance of variable-rate bonds, whereby the government is protected from interest rate fluctuations through a swapping arrangement, and leveraging the wider spread available between tax-exempt bond yields and higher available returns through the otherwise taxable investments that will be purchased by the OPEB trust. Numerous tax and regulatory issues undoubtedly need to be addressed in connection with these structures.

ANTICIPATED STATE LEGISLATION

In almost every case, legislation will be necessary to implement the changes needed to report OPEB liabilities on an actuarial basis. It is unlikely that current statutes provide the appropriate trust and other funding mechanisms that will enable most employers to establish and fund their OPEB most advantageously.

In addition, because most states and municipalities fund benefits on a pay-as-you-go basis, they have never had to address funding and investment issues with respect to OPEB, although they have addressed issues of retirement benefits. Many states will have to establish investment boards similar to those in place for retirement benefits, or, alternatively, they will have to assign joint investment responsibility to the body responsible for investment of retirement benefits.

Legislation will likely be required

to specify the type of funding arrangement and to assign responsibility for investment of assets. In addition, legislation may also need to specify whether separate trusts and funding arrangements are required for discrete groups of employees such as police officers, teachers, and judges in order to minimize the possibility that certain groups effectively subsidize costs for other groups.

It also may be desirable, to the extent possible, to decouple retiree benefits from the benefits available to active employees. In some cases there is an implicit subsidy of retiree costs by active employees. Isolating benefits may enable governments to negotiate more effectively for meaningful cost reductions with the employee groups with the most expensive benefit packages. Even legislative initiatives that are not controversial may encounter opposition if legislators are inclined to address broader issues relating to funding and benefit levels before they enact any legislation on the subject.

ISSUES OF STATE AND LOCAL RESPONSIBILITY

Special challenges need to be addressed at the state level with respect to benefits payable to local government, school district, and other local agencies. It is common for some employees of these local government entities to participate in state-sponsored retirement programs, and in most cases the amount and type of OPEB available are determined by the local government employer.

Although this degree of local control has not been an issue for most states with pay-as-you-go programs, entirely different issues are presented when benefits are funded. An extremely inefficient system will result if each locality and local agency establishes its own trust arrangement and hires its own investment manager. Some states are of the view that some of the smaller municipalities and agencies are ill equipped for self-management and should not be retaining investment managers and that this type of undertaking can be much more efficiently handled at the state level.

Thus, it is likely that many states will permit or even require municipalities and local governments to participate in state-sponsored programs. States that choose this solution and the municipalities that participate in those programs will likely face other issues. Mandated inclusion of a large number of multiple benefit arrangements in a single program with imposing uniform levels of benefits and providers will probably lead to administrative confusion and may result in increased costs as a result of program complexity.

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An alternative would be to make participation in a state-sponsored program optional on the part of the municipality or school district. States that choose this alternative must deal with the possibility of anti-selection; in other words, municipalities with larger unfunded liabilities will tend to join state-sponsored programs with the hope that the state and other municipalities will shoulder a portion of their costs. One solution might be for states to track costs for each individual municipality so that these costs can be fairly allocated.

Again, most states will need to enact additional legislation before they can make many of these decisions about individual programs and programs currently sponsored by municipalities and school districts. Inevitable delays in the legislative process need to be anticipated even though, in most cases, legislation must be in place before trust funds and other funding modifications can be implemented.

Careful consideration should be given to the scope and breadth of any legislation that addresses OPEB. Any item that affects benefit levels, or increases costs, or both is likely to become controversial and may cause needed enabling legislation to be delayed and thereby cause states and municipalities to miss critical deadlines.

THE CHALLENGE

Government employers face critical and immediate challenges with respect to their OPEB liabilities. It is imperative that they address these issues immediately and begin planning and implementing measures that will enable associated costs and liabilities to be properly managed and controlled. **PM**

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