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Public Employee Benefit Review

Newly Issued Accounting Standards for Postemployment Benefits other than Pensions

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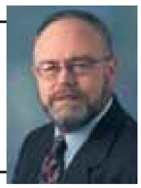

Introduction

In August, the Government Accounting Standards Board (GASB) released **Statement #45, Accounting and Financial Reporting by Employers for Postemployment Benefits other than Pensions (OPEB).** This new standard will affect the reporting and disclosure requirements of state and local government employers providing non-pension post-employment benefits such as retiree health and life insurance. Government employers providing post-retirement health insurance will typically show a significant cost increase in annual financial statements. In many instances, the difference will be dramatic.

Effective Dates

The effective date of GAS #45 depends upon the governmental employer's revenues *(earlier implementation is encouraged):*

Annual Revenues	Effective for Fiscal Years Beginning After
At least $100 Million	Dec. 15, 2006
From $10 Million to $100 Million	Dec. 15, 2007
Under $10 Million	Dec. 15, 2008

These dates allow time to prepare for compliance; however, employers should now begin to have the cost effects analyzed and to consider appropriate action to optimally manage plan costs. Employers should especially be aware of the cost implications when plan changes are being negotiated.

The Significance of GAS #45

The basic principle underlying the new standard is that post-employment benefits represent a form of deferred compensation for employee services rendered.

This premise leads to the concept that the cost of OPEB should be assigned to the period in which the services occur rather than with the later periods, after retirement or termination, during which the benefits are provided. The same concept underlies the existing standard for pensions, GAS #27, Accounting for Pensions by State and Local Government Employers. Accordingly, it is no accident that GAS #45 for non-pension postemployment benefits parallels in many respects the pension standard.

However, government employers with significant levels of OPEB coverage will typically see a much greater change in the amount they must recognize as the "Annual Required Contribution" (ARC) because most OPEB benefits are currently funded and expensed on a pay-as-you-go basis.

By contrast, at the advent of GAS #27 in 1998, state and local government pension plans were already typically being funded based upon the results of actuarial valuation methods that spread the cost over employment service. Applicable minimum funding requirements and GAS #27 standards were often so compatible that the ARC used in expense determination could be the same as the minimum funding requirement. This will not be the case with unfunded OPEB plans.

Required Valuations

Periodic actuarial valuations will generally be required to determine the appropriate expense amount and required disclosures. A valuation at least every two years will be required for a plan with at least 200 members *(active, deferred and retired)*. Plans with less than 200 members will need a valuation at least once every three years. A more frequent valuation may be necessary if factors such as design changes with a potentially significant effect on plan costs occur. An alternate measurement method in lieu of an actuarial valuation is available for plans with less than 100 members. Though GASB describes the method as "simplified" and "potentially usable by nonspecialists," the calculations are quite complex. The *illustration* of the method in Appendix F to the standard takes up 17 pages.

The permitted actuarial cost methods are the same as for GAS #27. Likewise, the parameters regarding selection of assumptions and amortization patterns are very similar, except for additional assumptions such as health care cost trend rates, which do not affect pensions. It is important to note, however, that if an employer with OPEB also sponsors a pension plan, the standard does not require the same actuarial cost method be used for both. This allows employers and their advisors more flexibility at arriving at a suitable approach. If an OPEB Plan is funded, and the funding requirements comply with the parameters required for determining OPEB costs under GAS #45, the same method is to be used for expensing and funding.

To Fund or Not to Fund

The advent of the standard may suggest a fresh evaluation of whether OPEB benefits should be pre-funded rather than on a pay-as-you-go-basis. Because pay-as-you-go contributions will generally be smaller, often much smaller, than the annual OPEB cost, a net OPEB obligation liability will gradually be built up. The size of the Net OPEB Obligation in the financial statement disclosures could affect bond ratings and the cost of borrowing.

But this is not the only reason to consider pre-funding. The annual OPEB cost is likely to be considerably higher for an unfunded plan than for a funded plan with the same benefits because of the required basis for selecting the investment return (discount rate) assumption. The standard requires that the investment return assumption be the estimated long-term yield on the investments used to finance the OPEB. Where no assets are being accumulated, the required rate is the expected return on employer assets, which are usually limited to fixed-income investments of short duration. On the other hand, if the employer is contributing the

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annual required contribution to an irrevocable trust, the expected rate of return on plan assets can be used. Assuming that plan assets were invested in a diversified portfolio similar to a pension plan, the investment return assumption could be higher. A higher investment return assumption leads to a lower actuarial cost and a lower annual required contribution (ARC) under the accounting standard.

Employer-Provided or Subsidized Benefits

The standard relates to plans where the employer covers all or part of the cost of the benefits, not coverage fully paid by retirees. But be aware that an employer may have an OPEB cost under GAS #45 for a post-retirement plan even where the retiree is charged the "full" premium! This can happen if active and retired employees are covered by the same health plan and the premium charged is calculated based upon the overall experience of the group rather than the experience of retirees only. In this case, the employer will generally be subsidizing the cost for the retirees who elect coverage because health care expenses typically increase by age. Because retirees will be older in age, on average, than active employees, annual retiree claims will typically be higher than active member claims. As a result, premiums for insurance covering both active and retired employees will be higher than if only actives were covered. GAS #45 will require that the subsidy be estimated and included in the determination of OPEB cost.

GAS #43 Changes Plan Accounting

Funded *(but not unfunded)* OPEB plans will also be affected by **Statement #43, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans.** This is a companion statement to GAS #45 much in the same manner that GAS #25, covering reporting by Pension Plans, was to GAS #27. Statement #43, only applies to plans being funded through trusts or other third-party arrangements. For example, pay-as-you-go arrangements, or the accumulation of assets that are not irrevocably committed to providing postemployment benefits would not be subject to this separate standard. At the current time, local government employers generally are not prefunding health or other postemployment benefits and would not be subject to Statement #43. However, GAS #45 may very well result in more employers deciding to prefund at least a portion of the cost in the future. The effective dates for GAS #43 are exactly one year earlier than for GAS #45.

LEGISLATIVE UPDATES

2003-2004 Legislative Session Wrap Up

The most significant legislation passed this session relative to pension funding, was Act 81 of 2004, which authorized filing revised 2003 actuarial reports to increase the amortization period for investment losses incurred in 2001 and 2002. The filing deadline for the revised reports was September 30, 2004. Those reports could be used to reduce the MMO payments for 2005 and 2005. Act 81 also increased the amortization period for actuarial losses resulting from killed-in-service benefit entitlements.

Act 43 of 2003 was passed in December 2003, reducing the service requirement for vesting in County pension plans to five years and adding two new class options (benefit multipliers).

Several other pension-related bills were passed in the last week of the legislative session. Act 169 of 2004 was signed into law on Nov. 29, 2004 amending Act 15, the Pennsylvania Municipal Retirement System (PMRS) law. This was a much anticipated change to the PMRS rules regarding the mandatory participation of permanent part time employees in the retirement system. Municipalities will now be permitted to elect whether or not to include part-timers, and provisions were established to handle existing part-time employees for plans currently participating in the system.

Two bills passed that amend the state domestic relations law and could impact on governmental pension plans. Act 144 of 2004 abolishes common-law marriages contracted after Jan. 1, 2005. This could affect surviving spouse death benefit entitlements in certain plans. And Act 175 of 2004 adds language specifying the method for determining the marital portion of benefits under defined benefit pension plans. This new language may provide much needed guidance in preparing Domestic Relations Orders in divorce proceedings.

The State Securities Act was amended by Act 128 of 2004, which essentially provides for municipal pension plans under Act 205 to be under the same rules as public school districts regarding Prohibited Advisory Activities and Prohibited Transactions.

Many were surprised that the DROP legislation (HB 2269) did not pass. The House passed HB 2269 on June 29, 2004, but the bill died in the Senate at the end of the session without ever coming out of committee. The bill would have amended Act 205 of 1984, authorizing what are referred to as DROP (deferred retirement option provision) plans, statewide for municipal pension plans. DROP plans allow retirement-eligible participants in defined benefit plans to "retire" from the plan, but continue to work while their monthly retirement benefit checks are set aside for them in the plan. Then when they actually leave employment, they begin collecting the monthly check, but also receive the payments that accrued during the DROP period in a lump-sum. This is the second legislative session that this bill has failed to become law.

Retiree Medical Liabilities May Soon Hit Your Financial Statements Like a "Ton of Bricks"

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If you offer medical benefits to your retirees, you may not want to postpone your actuarial study until the required implementation date under GAS #45. If you do, you may be surprised when you receive your first audit report with the new disclosure *(see Newly Issued Accounting Standards for Postemployment Benefits other than Pensions)*. The liabilities, which in most cases, have no offsetting assets, will likely be far greater than most employers anticipate.

Benefits of Early Assessment

The benefits of early assessment of Other Post-Employment Benefit (OPEB) liabilities far outweigh the false sense of financial security some may find in putting off the inevitable. The most pressing reason to calculate OPEB costs and liabilities now is for negotiating purposes. The true cost of retiree medical benefits, for example, has been largely ignored or overlooked as part of employee benefit packages. With the pending requirement to report this future liability as a cost that accrues over an employee's working career, like pension costs, it is critical that both sides of the bargaining table acknowledge it as such.

Governmental employers, including local governments, counties, school districts, authorities and states, have an opportunity to make a preliminary assessment of their OPEB costs and perhaps implement cost-containment or even cost-saving measures before the formal actuarial valuation is prepared for GAS #45 implementation. Certainly these measures can be achieved in negotiations through cost-sharing arrangements and benefit limitations. However, simply incorporating a more detailed explanation of benefits, eligibility and coverage into the written document or contract can help avoid expensive unintended benefit costs. Unclear OPEB documentation also makes it difficult for the actuary to make a projection of the benefit costs.

Discrepancies in the Interpretation of Retiree Medical Benefit Coverage

Let's say a contract simply states that "The employer will continue to pay premiums for an employee's medical benefits after retirement until Medicare eligibility." Presumably, "retirement" refers to when the employee retires under the eligibility requirements in the employer's pension plan. If employees can retire at age 55, the expectation is that the employer would be obligated to pay for the employee's health insurance for a maximum of 10 years. Ten years of health insurance premiums for each retiring employee would be relatively expensive. But, consider the possible other entitlements that may also be expected under this somewhat vague benefit provision. If the pension plan has a provision that allows employees to elect early retirement at age 50, they may believe that their medical benefits would be covered from age 50 to 65 if they retire early. The same could be assumed for disability and deferred vested retirees leading to many more years of medical coverage than expected or intended. Might an employee believe that the continuation of premiums would be at whatever coverage (single, family or husband/wife) the employee was under before retirement? What if the employer changes providers or plans after an employee retires? Does this language preclude the employer from moving retirees to the new plan? And, does "Medicare eligibility" mean when the employee becomes eligible, or could it be interpreted that if the spouse was covered, premiums will be paid until each become eligible for Medicare? The number of ways in which the language in this example could be misinterpreted or exploited is endless.

Usually discrepancies in the interpretation of retiree medical benefit coverage don't become an issue for many years after the provision is first written into a contract. Many times, this type of benefit is agreed to at a time when no one in the foreseeable future will be entitled to it, thus creating the perception that there would be little cost. The language is finally put to the test when the first few employees actually request the coverage.

'An Ounce of Prevention is Worth a Mound of Grievances, Attorney Fees, and Benefit Costs'

As they say, 'an ounce of prevention is worth a mound of grievances, attorney fees, and benefit costs,' or something like that. There are many other aspects of the new OPEB disclosure requirements to consider, such as whether or not to start funding the liabilities (like pension plans). Government employers that provide or are considering providing retiree medical benefits or other benefits such as life insurance, prescription drug plans, vision or dental insurance should contact their actuary and auditor very soon to begin assessing how the cost of these benefits may impact on their financial status, borrowing ability/capacity, and credit/bond rating. Discussion of these costs should take place before the next contract negotiations.

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IN BRIEF

Balance of 2004 MMO must be deposited to pension plan by Dec. 31, 2004

Check on pending pension legislation and other important news and information or download prior issues of the PEBR from our website at **www.mockenhauptbenefits.com**

Act 81 Follow-up:
We received many questions from clients asking about the number of municipalities electing to submit revised 2003 actuarial reports under Act 81 to reduce pension costs. According to the Public Employee Retirement Commission, there were 350 revised reports submitted and accepted for pension plans from 235 municipalities. There are roughly 2,200 defined benefit plans under Act 205 statewide. However, only defined benefit plans that had an unfunded liability and actuarial losses from 2001 and 2002 due to investments were eligible to re-file.

2004 State Aid Unit Value Holds Up Under Pressure
Contrary to what most people in the business (including us) expected, the 2004 state aid unit value came out at $2,911, a slight increase from the 2003 value of $2,894. Preservation of the unit value amount, despite significant increases in funding needs and the number of plans requesting funds statewide, is being attributed to a 17.5 percent increase in revenues to the state aid pool. This is the largest increase in revenue in 17 years, over which period the average yearly increase was only 3.4 percent (and three of those years it decreased).

Next issue: *The Guiding Principles of Pension Plan Administration* and another Client Profile

Do you have a suggestion for an article for a future newsletter? Call us at (800) 405-3620