THE CITY OF FORT LAUDERDALE

OFFICE OF THE CITY AUDITOR

A review of Other Postemployment Benefits (OPEB) and GASB 45

June 4, 2008

Prepared By: Alexandria Woolweaver

Executive Summary

Government Accounting Standards Board (GASB) Statement Number 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pension, represents a substantial change in governmental accounting and financial reporting that will substantially influence monetary decision making in the public sector over the next decade. This dramatic change in governmental accounting by state and local governments for Other Postemployment Benefits (OPEB) moves it from a cash (i.e. pay-as-you-go) basis to an accrual basis. The rule was issued by GASB in 2004 and goes into effect starting this year. The new standards will require state and local government entities to disclose the full cost of non-pension related retirement benefits. Published estimates of the 88,000 state and local governments' OPEB liabilities have been quoted at $1 trillion; however the value of this estimate will not be confirmed until 2010 when all governmental entities are required to begin reporting their exposure.

Statement of Intent

This paper is not intended to recommend a particular method for funding the cost of OPEB. Instead, the purpose of this paper is to inform the reader as to the impact of GASB 45 on governmental accounting and funding for future retiree costs and to provide policy makers with information for decision-making.

Background

OPEB is defined as all postemployment benefits, other than the pension plan, provided by a state or local government to their employees. The largest of these benefits is retiree healthcare (e.g. Medical, dental, vision, hearing etc.). OPEB can also include postemployment life insurance, disability, and long-term care. Each state and local government has its own unique mix of benefits and provides varying levels of coverage. Currently, when a state or local government pays benefits to retirees it recognizes the cash spent and records the corresponding expense on the income statement. This approach can be problematic because the expense being recognized today is for the benefits paid to retirees who have long since performed their service and earned the benefit they now receive. On the other side of the spectrum, the employer has also promised current employees and retirees a future benefit, but the obligation to provide it and the cost of the benefits as they are being earned is not reported anywhere in the financial statements nor is it otherwise disclosed. This causes an understatement in both liabilities and expenses and therefore does not provide an accurate financial snapshot of the public entity.

With the adoption of Statement 45 by the Governmental Accounting Standards Board, state and local governments will now be required to determine and report the Actuarial Accrued Liability (AAL) of these benefits. This is defined as the present value of the future OPEB benefits that have been promised and earned by its employees to date.

GASB 45

Under GASB 45, the OPEB expense that is reported on the income statement will be very different than it is today. Statement 45 was issued to provide more complete, reliable, and decision-useful financial reporting regarding the costs and financial obligations that governments incur when they provide postemployment benefits other than pensions as part of the compensation for services rendered by their employees. Postemployment healthcare benefits, the most common form of OPEB, are a very significant financial commitment for many governments.

The standard also:

Results in reporting the estimated cost of the benefits as expense each year *during the years that employees are providing services* to the government and its constituents in exchange for those benefits.

Provides, to the diverse users of a government's financial reports, more accurate information about the *total cost of the services* that a government provides to its constituents.

Clarifies whether the amount a government has paid or contributed for OPEB during the report year has covered its annual OPEB cost. Generally, the more of its annual OPEB cost that a government chooses to defer, the higher will be (a) its unfunded actuarial accrued liability and (b) the cash flow demands on the government and its tax or rate payers in future years.

Provides better information to report users about a government's *unfunded actuarial accrued liabilities* (the difference between a government's total obligation for OPEB and any assets it has set aside for financing the benefits) and changes in the *funded status of the benefits* over time.

Source-www.GASB.org

Annual OPEB cost is equal to the employer's annual required contribution to the plan (ARC). The ARC is defined as the employer's required contributions for the year, and includes (a) the normal cost for the year and (b) a component for amortization of the total unfunded actuarial accrued liabilities (or funding excess) of the plan over a period not to exceed thirty years. The parameters include requirements for the frequency and timing of actuarial valuations as well as for the actuarial methods and assumptions that are acceptable for financial reporting.

The ARC can be evaluated by comparing it to total government revenues and covered payroll. Other measures would compare ARC growth to the growth in the cost drivers of the OPEB liability. These include healthcare cost trends, growth in plan participation, and salary increases. Of these, the healthcare cost trend merits particular attention because it has been growing at a rate that far exceeds the general rate of inflation.

Measuring OPEB Liability

To determine the funded status of the plan, GASB 45 requires a comparison of the AAL to the actuarial value of plan assets. This calculation does not fully capture the underlying economics of the OPEB plan. This is because the actuarial value smoothes the asset value over time rather than state the fair value of plan assets. To fully analyze the impact of the liability, the retiree and survivor population must be known and the government's portion of the contribution to OPEB costs versus the employee's contribution must be disclosed. The analysis must also include the discount rate and medical cost trends used in the valuation.

The discount rate that is used to arrive at the AAL is the expected return on the assets that will be used to pay for the OPEB benefits. If the plan is fully funded, the discount rate is the expected return on plan assets. If it is not funded, it is the return on employer assets, which in most cases will be lower. If it is partially funded, it is somewhere in between. This provides an incentive for state and local governments to pre-fund the plan and invest in higher-returning asset classes like equities, since using a higher discount rate will result in a smaller present obligation.   Simply stated, this means that pre-funding the plan reduces the OPEB obligation on the income statement.

Bond Rating Agencies

There has been concern on how the bonding agencies will react to the implementation of GASB 45 and the increased liability and the reduction of assets due to an unfunded OPEB plan. State and local governments rely on bonding agencies to give them a high rating so they can receive a lower interest rate in the new bond issues.

The following table represents the views of the bonding agencies on pre-funding OPEB plans concerning bond ratings.

Credit Rating Agencies

Fitch – The switch to actuarial funding from a pay-as –you-go practice may have a sizeable fiscal impact. Fitch Ratings believes that meeting actuarial funding requirements for OPEB will be a stabilizing factor and protective of credit over time. A steady progress toward reaching the actuarially determined annual contribution level will be critical to sound credit quality. An absence of action to fund OPEB liabilities or otherwise manage them will be viewed as a negative rating factor.
Moody's- Governments will have strong incentive, though not obligation, to set aside funds for benefit obligations as they are incurred, which is in keeping not only with accounting principals but also with prudent financial management.
Standard & Poor's- Depending on the size of the plan, including the number of employees and the level of benefits in relation to an entities budget, advance funding of the plan under the new rules may add stress to the budget. On the other hand contributing to PAYGO amount will result in a growing unfunded actuarial liability and net OPEB obligation. The advance funding of OPEB presents a vehicle for employers to build an asset base to offset the actuarial accrued liabilities and provide for payment of the benefits as they come due in future years. Advance funding of OPEB would generate both real cost savings from investment earnings and more favorable liability calculations.

Source- Fitch, Moody, & Standard & Poor

Financial Statement Recognition & Disclosures

GASB 45 does not require that the cost of the plan be 100% funded, only that the municipality acknowledges and disclose the costs. Employers are required to provide descriptive information about each OPEB plan in which they participate, including the funding policy followed. In addition, employers are required to disclose information about contributions made relative to the annual OPEB cost, changes in the net OPEB obligation, the funded status of each plan as of the most recent actuarial valuation date, and the nature of the actuarial valuation process and significant methods and assumptions used. They are also required to present as required supplementary information a schedule of funding progress for the most recent valuation and the two preceding valuations, accompanied by information regarding factors that significantly affect trends in the amounts reported. Implementation is required in three phases based on the government's total annual revenues in the first fiscal year ending after June 15,1999.   The City of Fort Lauderdale will be implementing GASB 45 effective Fiscal Year 2008.

City of Fort Lauderdale OPEB

Currently, the City of Fort Lauderdale only has one direct OPEB obligation to employees. Effective October 1, 2000 (Ordinance C-01-11), the City began providing a fixed dollar contribution to help subsidize the cost of retiree medical care. General Employees are provided with a monthly payment of $200 and Management, Police and Fire receive $400 monthly upon normal retirement, until age 65 or death. This amount does not adjust to reflect increases to current medical care rates. Unlike other municipalities that provide a full range of benefits, this plan is fixed and will not grow exponentially as healthcare costs rise.

The City recently put out an RFP for an actuarial evaluation for postemployment benefits to comply with its GASB 45 reporting requirements. The contract was awarded to Bolton Partners who will perform the actuarial review and determine the amount of the unfunded liability and the ARC. The report should be released shortly.

The City also has an indirect liability that does not need to be recorded in the City's financial statements. This liability is the result of all retires having access to the City's medical plan. According to Florida Statutes 112.801, retirees and their eligible dependents shall be offered the same health and hospitalization insurance coverage as is offered to active employees at a premium cost of no more than the premium cost applicable to active employees. The overall group premium rates are higher as a result of the increased experience rating from retirees who generally have both more frequent and more expensive claims

FINANCING OPTIONS

Governments have been examining various funding options to cover the cost of their OPEB plans. Some cities and states that have large OPEB obligations have set up trust funds with proceeds from the sale of surplus real estate or privatization of assets. Other governments are considering OPEB bonds. OPEB bonds may allow for a net positive arbitrage between the taxable issue and the trust's investment returns. Finally, some governments have set up separate funds that are funded through annual budget appropriations to reduce the OPEB liability and move to a funded plan.