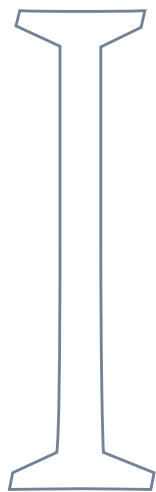


Accounting Quandary for Health Benefits in Retirement

BY KEVIN BINDER

Differing opinions on discount rate selection under a new government accounting standard could lead local governments to unintentionally mislead creditors about their financial obligations for retiree health benefits.



IN JUNE 2004, THE GOVERNMENT ACCOUNTING STANDARD, BOARD

(GASB) adopted statement 45 (GASB 45) revising generally accepted accounting principles for governmental employers who provide other post-employment benefits (OPEB). Previously, governments accounted for OPEB on a pay-as-you-go basis.

The new standard, effective for large governments (revenue in excess of \$100 million) for fiscal years starting after Dec. 15, 2006, requires accrual accounting with the expense designated as the annual OPEB cost (AOC).

Because the standard is purely an accounting standard, there's no requirement for governments to prefund OPEB. However, the difference between the expense and OPEB expenditures creates a liability on the government's statement of net financial position—similar to an accrued expense under financial accounting standard (FAS) 106—called the net OPEB obligation (NOO). The accrued liability and assets (if any) are footnote disclosure items. The method and assumptions used to determine the accrued liability are also disclosed in the footnotes.

A common reaction to the new accounting standard increased contributions to a pension-like trust, which will be recorded as an expense. There are two predominant views on how best to select the discount rate for measuring OPEB liabilities during the phase-in period. But each has serious deficiencies.

Choosing a Discount Rate

The GASB 45 standard is patterned after GASB 27, the standard for pension accounting. Under GASB 27, the discount rate is based on the long-term expected rate of return of assets in the pension trust. For governments establishing such a trust and adopting a funding policy to contribute at least the expense into the trust, the discount rate selected is similar to that under the ERISA funding standard account before passage of the

Pension Protection Act of 2006. Governmental pension plans typically use discount rates from 7 percent to 8 percent.

However, there's no requirement to fund OPEB, and, until now, most governments haven't prefunded them. If a government doesn't establish a trust to prefund benefits, the GASB standard dictates that the discount rate be based on the asset return of the government's liquid assets. These are typically short-term money market rates of around 4 percent.

If the government decides to prefund an amount that is less than the expense determined under the funded discount rate but more than current pay-as-you-go costs, then the discount rate should be a partially funded discount rate somewhere between the funded and nonfunded discount rates. According to the language in GASB 45, "The discount rate for a partially funded plan should be a blended rate that reflects the proportionate amounts of plan and employer-provided assets expected to be used."

In sum, the discount rate under GASB 45 depends on two factors—the level of trust contributions under the government's funding policy and the asset mix of the trust. Governments intending to contribute at least the entire expense into an OPEB trust can use a funded discount rate (similar to pension plans) of 7 percent to 8 percent. Governments that have decided not to prefund OPEB plans can use

County A – Fully Funded Principal GASB 45 Valuation Results

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Discount rate	7.75%	7.75%	7.75%	7.75%	7.75%
Beginning of Year (BOY) liability	149	161	174	188	202
BOY assets	0	10	20	31	43
BOY NOO	N/A	—	—	—	—
AOC	14	14	15	15	16
Trust contribution	10	10	9	9	9

County B – Partially Funded Principal GASB 45 Valuation Results Year-by-Year Approach

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Discount rate	4.75%	5.50%	6.25%	7.00%	7.75%
BOY liability	264	252	238	221	202
BOY assets	0	2	6	13	23
BOY NOO	N/A	16	29	38	43
AOC	22	22	21	20	17
Trust contribution	2	4	6	9	11

County B – Partially Funded Plan Principal GASB 45 Valuation Results Long-Term Approach

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Discount rate	7.75	7.75%	7.75%	7.75%	7.75%
BOY liability	149	161	174	188	202
BOY assets	0	2	6	13	22
BOY NOO	N/A	8	14	18	20
AOC	14	15	16	17	17
Trust contribution	2	4	6	8	10

an unfunded **discount rate** of around 4 percent. Governments that contribute something less than the funded expense but more than the pay-as-you-go GASB 45 expense can use a partially funded discount rate.

A government's expense under the new standard depends upon its funding policy. Clearly, the cost to the government is much lower if it establishes a trust and prefunds the benefits. While there's no requirement to contribute the expense into a trust, there's a powerful incentive to do so.

But the accrual cost, even under the higher funded discount rate, is typically much greater than the current pay-as-you-go cost. Many governments can't afford to contribute the funded expense into the trust—at least in the short term—and instead plan on gradually increasing their contributions with the goal of eventually reaching the fully funded level. The state of Maine has announced that it plans on taking 15 years to do so. Other gov-

ernments have passed resolutions with a five-year funding plan.

The GASB standard states that any discount rate selected must be based on the government's funding policy. Should actuaries consider the funding policy for just the year in question? Or do we look at the long-term funding policy? The two most common methods of selecting the discount rate in the phase-in period hinge on the answers to these questions.

The first method, what I call a year-by-year approach, looks at the funding policy for the year in question. For example, suppose the unfunded discount rate is 4 percent and the funded discount rate is 7.75 percent. The discount rate during the five-year phase-in period would be 4.75 percent in the first year, 5.50 percent in the second year, 6.25 percent in the third year, 7 percent in the fourth year, and 7.75 percent at the end of the phase-in period.

The second method, what I call a long-term approach, is to consider the long-range funding policy. Over its duration, the plan will come fairly close to fully funding the AOC. In fact, some governments have considered a funding policy that will pay down the NOO that accumulates during the phase-in period after the phase-in is completed. For example, consider a government that has adopted a 25-year funding policy. Under the funding policy, trust contributions in the first five years will gradually increase to equal the expense. Contributions from the sixth year on

will equal the expense plus a 20-year straight-line amortization of the NOO at the end of the fifth year. Such a policy would fully fund the AOC over 25 years, averaged out, and the discount rate would be 7.75 percent throughout the period.

The Quandary

So, which is the best way to go? To illustrate the quandary, consider four county governments. Each government sponsors identical OPEB plans with identical employee demographics and medical claims experience. Prior to GASB 45, each plan was unfunded.

- **COUNTY A** fully funds the OPEB expense from the first year.
- **COUNTY B** adopts the 25-year funding policy described above. In the first five years, trust contributions gradually increase to equal the expense. In the remaining 20 years, trust contributions equal the expense plus a 20-year straight-line amortization of the NOO at the end of the fifth year.

A government's expense under the new standard depends upon its funding policy. Clearly, the cost to the government is much lower if it establishes a trust and prefunds the benefits.

► **COUNTY C** adopts the same funding policy as County B. However, unlike County B, each year, County C finds that it's unable to meet the funding requirements of its policy. In fact, it's unable to make any contribution to the trust at all, revising the funding policy to delay the phase-in by a year. In the fifth year, the new policy is to phase in funding for the next 25 years.

► **COUNTY D** simply decides not to prefund benefits.

Let's compare County A and County B principal valuation results over the first five years using the year-by-year approach to selecting the discount rate.

What's wrong with this picture? County B contributed \$21 to the OPEB trust over the first four years. That's \$17 less than County A contributed over the same four-year period. Yet County B's NOO is \$43. Keep in mind that only the NOO appears in the financial statements; the other items are footnote disclosures. So it appears to the casual reader comparing the financial statements of County A and County B that the latter is \$43 behind the former in its funding. In fact, County B contributed only \$17 less than County A to the OPEB plan.

The inconsistency stems from the use of the lower discount rate in the phase-in period, which increased the expense in the phase-in years. Under a long-term approach to setting the discount rate in the phase-in period, this problem disappears.

Using the long-term approach, County B's NOO is \$20, which is approximately equal to the difference in its contributions to the trusts and County A's contribution adjusted for interest.

This comparison illustrates that if a government entity follows through on its planned funding policy, at the end of the funding period, the long-term approach results in an NOO that is comparable to an entity that was always fully funded. The year-by-year approach doesn't.

To illustrate the potential pitfalls in using a long-term approach to set the discount rate in the phase-in period, let's look at the same illustrations for County C under the long term approach and County D.

County C and County D are identical in their actual funding. Yet County D has nearly double the NOO, and its footnote disclosure will have nearly double the level of underfunding.

If County C had used the year-by-year approach to setting



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**County C - Unable to Meet Goal of Partially Funding Plan
Principal GASB 45 Valuation Results, Long-Term Approach**

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Discount rate	7.75%	7.75%	7.75%	7.75%	7.75%
BOY liability	149	161	174	188	202
BOY assets	0	0	0	0	0
BOY NOO	N/A	10	20	31	43
AOC	14	15	16	18	19
Trust contribution	0	0	0	0	0

**County D - Unfunded
Principal GASB 45 Valuation Results**

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Discount rate	4.0%	4.0%	4.0%	4.0%	4.0%
BOY liability	292	313	333	356	378
BOY assets	0	0	0	0	0
BOY NOO	N/A	19	39	60	82
AOC	23	25	26	28	30
Trust contribution	0	0	0	0	0

the discount rate, its financial disclosure and NOO would be identical to County D's.

This comparison illustrates that if a government doesn't follow through on its planned funding policy at the end of the phase-in period, the year-by-year approach results in an NOO that is comparable to that of an entity that didn't plan on and isn't prefunding OPEB liabilities. The year-by-year approach doesn't.

To summarize, if the goal of the GASB standard is for government financial statements to be comparable, then:

- › The long-term-approach is better for governments that follow through on their phase-in plans, and
- › The year-by-year approach is better for governments that do not follow through on their phase-in plans.

The problem is that no one really knows which governments will follow through on their phase-in plans and which will not.

Possible Solutions


Actuaries need to make plan sponsors aware of the pitfalls of both approaches. Given the complexity of this issue, I have found this to be quite a challenge. I would suggest there will be a fair percentage of governments that aim for eventual full funding but are unable to reach their targets. This will be true even for governments in wealthy jurisdictions because these are the jurisdictions that also tend to have the most generous benefits.

What may make meeting these funding targets especially difficult is their uncertainty. Unlike a pension benefit that's defined, most OPEB plans promise to provide services with unknown costs. There's the distinct possibility that costs will increase faster than the medical-trend assumption. Put another way, there will be a significant percentage of governments with phase-in funding plans that never get there.

Given this possibility, I recommend using the year-by-year approach. However, when a government reaches its full-funding target, there will be the problem that the NOO is overstated, at least compared to a similar government that was always fully funded.


To address this shortcoming, I have two suggestions, one for the individual actuary working in conjunction with the government and its auditors and the second for the actuarial profession as a whole.

I would suggest that the footnote to the financial statements provide a separate hypothetical expense and hypothetical NOO calculation at the fully funded interest rate. The footnote would explain that the government has a long-term plan to be fully funded. It would also explain that the hypothetical expense is meant to show



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I would suggest there will be a fair percentage of governments that aim for eventual full funding but are unable to reach their targets. This will be true even for governments in wealthy jurisdictions because these are the jurisdictions that also tend to have the most generous benefits.

the eventual cost of the plan after the phase-in period is completed and that the hypothetical NOO is meant to provide a more consistent comparison with fully funded entities. This solution would have to be discussed with the government and its auditors.

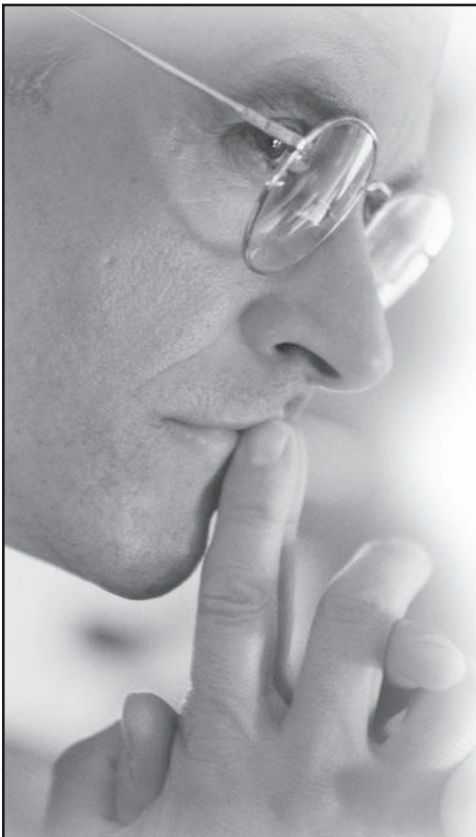
While the additional information would enable creditors to readily compare the financial statements of governments with phase-in funding to those that are fully funded (governments A and B above), it would still leave an inflated NOO in the statement of net financial position at the end of the phase-in period.

I believe that the actuarial profession needs to work with the GASB to remedy this inconsistency. Perhaps the GASB would consider allowing governments that reach the fully funded level for a certain period to reset their NOO to the hypothetical NOO or something like the hypothetical NOO.

There certainly is going to be a lot of diversity of practice in this area. It's important that the profession work creatively with government financial officers, auditors, and the GASB to provide financial statements that are both useful and comparable. ●

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