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Government Accounting Standards Board Postretirement Benefits Accounting Standard Update

Track: Pension, Health

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Summary: Attendees are updated on the Government Accounting Standards Board's (GASB) progress in establishing new recognition and disclosure requirements for postretirement benefits other than pensions. The GASB's perspective and possible ramifications of the new requirements are discussed.

MS. MARILYN MILLER OLIVER: I'm Marilyn Oliver from Oliver Consulting. Karl Johnson is the GASB Other Postemployment Benefit (OPEB) project director. John Bartel is a vice president of AON Consulting. Bill Reimert is a senior consultant with Milliman USA.

Karl's going to give an overview of the exposure draft, its current status and some of the comments that they have received to date. John is going to go through the details of some of the calculations in the exposure draft and give the results of some calculations he has made for different groups. Bill is going to talk about special issues.

How many of you have public sector as your primary area of practice? About 50 percent. How many have read the exposure draft or reviewed it? About 70 percent have. How many have done an OPEB study under the exposure draft? Two people. How many have performed an OPEB study under Financial Accounting Standard (FAS) 106? Almost 90 percent have.

MR. KARL JOHNSON: We have had a lot of input for the exposure drafts and a lot of help from quite a number of actuaries throughout this process. We've had, I believe, four or five actuaries and benefit consultants on our task force, including

Bill and John. We've had a lot of correspondence and a lot of conversation with other members of the Academy as well, but ultimately I guess we're responsible for the decisions that have been made by the GASB, for good or ill.

I am going to go through and give you an overview and highlights of the recent exposure drafts. I will try to comment on some of the issues that have turned out to be controversial as we've received comments. We've issued exposure drafts, the comment period is over, and we've had public hearings. Now the Board is in the process of reviewing comments, trying to see if there are new arguments or new information that would cause them to change any of the tentative decisions that are reflected in the exposure drafts (EDs). We are still trying to get to a position of balloting the members to approve issuance of final statements by December 31, although we have a great deal of work ahead of us.

The views that I express are mine and not officially those of the Board, and the Board can change its mind right up until December 31 or whenever they ballot final statements.

Currently there are three standards that apply to a government's accounting for postemployment health-care benefits or other forms of postemployment benefits, other than pensions. The first one is GASB Statement 10 on accounting for risk financing activities. That statement says that if a government is providing health care to active employees and to retirees, and they're accounting for the retiree portion of the benefits on the basis of claims incurred, then they should go by the guidance of Statement 10 as to what fund type to use and some of the details of accounting for that. But Statement 10 doesn't require a projection of benefits for the retirees and doesn't provide any guidance for anyone that does that.

Statement 12, which was issued in the same year as FASB Statement 106, I would characterize as a weak disclosure standard. It does require identification that an employer is providing postemployment benefits, with a little bit of numerical information to the extent that it's available. It's very permissive in that way. Statement 12 says in passing that governmental employers are not required to apply FASB Statement 106 measurement requirements when that statement comes out. I think Statement 12 came out a couple of months before Statement 106.

In 1994 when the GASB issued its set of pension standards, one of the three, Statement 26, was another interim statement (in addition to Statement 12) related to OPEB. Statement 26 applies to accounting for situations where a postemployment health-care plan is administered through a defined benefit pension plan. Basically, Statement 26 says in that case you have two plans, and you have to segregate the financial reporting for the health-care plan. However, it does not require actuarial valuations or actuarial information for the health-care component.

In 1995 and 1996 the Board discussed OPEB. The idea was to try to move quickly to adopt OPEB requirements that would be parallel to the requirements of

Statements 25 and 27 on pension reporting. However, the Board was also working on its new financial reporting model that became Statement 34 at the same time and was not able—either the Board or the staff—to handle both projects at the same time. As a result, the OPEB project was put on hold and remained in that status for a little over three years. We resumed discussion of OPEB in August 1999, by which time we had a newly expanded Board. Accordingly, we spent a great deal of time on review and education sessions initially, and we've been working on this project pretty consistently up to February 2003, when we issued exposure drafts.

In our lingo OPEB refers to postemployment benefits other than pension benefits. It includes postemployment health care, and it also includes other types of benefits such as life insurance if they're provided separately from a pension plan. The main significance of this is just to identify which standard you go by. If life insurance and things of that sort are provided through a pension plan, you go by the pension standard. It probably doesn't make too much difference which standard it falls under because, as we'll talk about, we've followed the same approach in both of them.

Several months ago I realized that one of the most common types of questions we were getting had to do with whether a certain type of benefit that someone was dealing with, either themselves or a client, was OPEB or whether it would fit under the OPEB standard. To address those questions, I put together a few points on things that either are not OPEB or they may be OPEB but they're not necessarily required to be measured and reported as such. The first of these is what we're calling "termination offers and benefits." That term includes special termination benefits, early retirement incentive programs—whatever they may be called. The main characteristic would be payments that are not compensation for services, but they're intended to bring an employee's services to an early end.

Conceptually we believe these are different from OPEB and should be accounted for differently. However, if a termination offer takes the form of an increase in a pension benefit or a postemployment health-care benefit, or anything of that sort, then we have said that we would like that increase accounted for under either the pension requirements or the OPEB requirements. The purpose of that is to account for the whole benefit under one standard rather than carving out the part of it that comes about as a result of an early retirement incentive under a different standard.

The second thing that would not come under the OPEB standards, and this one's quite common, is what I'm calling sick leave conversions. These are the arrangements whereby unused sick leave is converted to an individual defined contribution health-care account and later applied as the retiree's share of the premiums in retirement. GASB Statement 16 on accounting for compensated absences requires that sick leave be accrued during employment as a liability and an expense if it's going to be satisfied through termination payments. That would include both direct cash payments to the individual and cash payments to a third party for a health-care account. I think it would also include cases where the employer just simply holds the money or keeps accounts and then later pays out the money on the retiree's behalf. Those liabilities and expenses are fully accrued by the time that an employee terminates. As the employer pays out the money later, or a third party pays out the money later, that's simply satisfying an obligation that's already existed. It does not create any new OPEB on the employer's part. There's a natural question here: because it seems like the employer's paying premiums, wouldn't that be OPEB? No, because this benefit has already been accrued previously.

The third situation is extremely controversial. You may have seen the letter from the American Academy of Actuaries that they wrote us in December 2002 about the implicit rate subsidy exemption issue. Paragraph 6(a) of the employer exposure draft proposes to exempt what we're calling an "implicit rate subsidy" from being accounting for as OPEB. The situation addressed is where you have both active employees and retirees in the same plan, and the retirees are benefiting from a subsidy equal to the difference between the premium that's assigned to them—which, for example, might be the average premium for all active employees and retirees in the plan—and what the premium would be if measured based on the claims cost for the retiree age group.

Further, we've limited the proposed exemption to situations where the employer does not explicitly contribute any cash. In other words, they don't contribute any cash that they have identified as an employer contribution. If the retiree pays all of the premiums assigned to them, let's say that's the common premium or the average premium, then the employer would not be required to apply the measurement requirements of the OPEB standard to compute the cost and the accrued liabilities associated with the implicit rate subsidy.

After a lot of discussion, the basis for conclusions to the exposure draft does acknowledge that conceptually and under the main requirements of the standard an implicit rate subsidy is OPEB. The Board has just decided for cost benefit reasons not to require employers to do the measurement in those limited situations.

The Board believes the substance of the OPEB transaction is an exchange of services for benefits, and really everything else follows from that. We also considered but rejected the view that OPEB is some kind of gratuity that's offered by a beneficent employer that doesn't have anything to do with any benefits that the employer has received. Some government people believe that is what it is, but we don't believe that makes any sense.

The Board's view is that the benefits are earned. The employers are incurring costs, whether or not they choose to fund it at the same time, and benefit obligations are accruing as services are rendered during employment. The payment or provision of the benefits is delayed until later. That sets up the conditions for accrual accounting.

The current GASB Statement 34 requires government-wide financial statements prepared on an accrual basis of accounting. Those encompass all governmental and business-type activities of the government, but there's no uniform accrual basis standard for OPEB. Employers may apply GASB Statement 27, which is the employer pension reporting standard, but hardly anyone does. In addition, they're not precluded from applying FASB 106, but if there's anyone doing that, it would be extremely rare.

In current practice most plans, we believe, have never had an actuarial valuation performed. A lot of decisions have been made based on pay-as-you-go information. The plans are generally financed on a pay-as-you-go basis. The financial statements don't report any effects of the underlying transaction until the benefits finally are paid, often many years after the fact.

Accordingly, the financial reporting generally doesn't recognize the cost of the benefits when it's incurred, doesn't provide information about accrued liabilities for promised benefits that are associated with services already received, and doesn't provide information that's reliable as far as getting a handle on future cash-flow requirements.

The first two objectives really have to do with recognizing the cost or expense over periods that approximately coincide with employees' years of services. We're not too strict about that in comparison to the FASB requirements, but generally that's the idea. We want to get expense accrued over the service period rather than when it's paid. We want to provide information about the actuarially accrued liabilities, about the actual cost of providing the benefits each year and the way that it contributes to the total cost of government services, and about the progress, if any, that's being made in funding the plan.

I would say, of all the response letters that we have received, the most energy probably went into disputing this understanding of the nature of OPEB. We were challenged on the basic idea that accrual accounting should be required, and those responses generally fall into accounting and nonaccounting reasons. The accounting reasons are very similar to objections that FASB also received years ago. Those basically stated that there's not an accruable liability or that the liability changes too much or is too hard to estimate.

We also received a lot of nonaccounting arguments that really are along public policy lines. These were, in effect, that if you require governments to measure and know this information, and you require them to publicly report it to others, then they will stop doing the benefits, and that will have undesirable policy impacts. I don't believe that these arguments are generally new, because they're generally not anything that the Board was not aware of or did not consider. I think it's very unlikely that anything will change as a result.

The last objective, which is special to the GASB, is that we will require that OPEB be reported in a manner that's generally consistent with requirements for reporting pension benefits so that a government that's under GASB standards would report all postemployment benefits using the same approach. That approach is often called a funding-based approach to reporting pensions. When we created the pension standards, funding was already generally in place for governmental plans. We built the accounting on that in a way that we thought fairly handled the accrual accounting objectives. We made an explicit decision to try to harmonize the accounting with funding, whereas FASB in contrast said that the two are different and took a more prescriptive approach.

OPEB plans are not funded. That was kind of a hurdle that we faced, but we decided to go ahead with the same general approach. We sometimes characterized that approach as being "funding friendly" as it applies to OPEB, because if anyone does fund now or decides to fund later, they would not have to have two different measurement systems. The measurement approach, viewed from a very high level, is to project the cash outflows for benefits, discount to present value, and allocate using an actuarial cost method.

The projection of benefits should be based on the substantive plan. This is similar to the FASB substantive plan notion. Again, this was a controversial point. I think a lot of people who objected to accrual accounting were very uncomfortable with the going-concern kind of assumption built into that. Some people would like to recognize future changes that they might make in plan provisions or future changes that might occur in the environment, such as Medicare pickup of prescription drugs, as part of the assumptions used in projecting benefit payments. Basically we're saying that you would account for the kinds of benefits being provided at the time of the valuation. Also you would take into consideration the pattern of sharing of benefit costs between the employer and plan members to that point.

We did not mention caps on employer contributions in the exposure drafts, and that caused a lot of consternation among some respondents. The Board had discussed that, however, and I think in the final statements we will explicitly address that and say that caps should be taken into consideration in projecting benefits. Part of that would be considering whether you believe that there is an effective cap. If, for example, there's a cap, but it's been reached twice, and it's been raised each time it was reached in order to keep on doing the same, then you'd have to question whether or not there's really a cap.

The standards would require periodic actuarial valuations in accordance with our parameters or, for sole employers in plans with fewer than a hundred total members, including active and retired, calculations using a simplified alternative measurement method that's pretty much created by GASB staff. The Board was very concerned about the cost of application of the standards for very small governmental plans, of which we think there are a great many.

Plans with 200 or more total members would have biennial valuations at a minimum. Plans with fewer than 200 could have triennial valuations. However, those that have less than a hundred could apply the alternative measurement method as an option. The alternative measurement method is illustrated in the employer's exposure draft. It involves the same three broad measurement steps as an actuarial valuation. However, it's simplified to where we hope that many nonspecialists or nonactuaries could perhaps apply the method. It does allow simplification of some of the assumptions, and some of those we know affect the accuracy, but they were allowed in order to try to make it doable by some.

Now, this also has drawn a lot of comment from respondents. Probably more respondents are for having an alternative measurement method than are against. Those in favor are primarily looking at the potential for saving money, I guess, on the implementation cost. We've also had a lot of people who were not in favor of the proposed method. A lot of the auditors have problems with it. Instead of relying on the work of a specialist, they would have to review more closely, perhaps, calculations that were done by nonspecialists who could have created errors, either through bias or through just inexperience or lack of expertise.

Another issue we're going to be talking about is discount rate. The discount rate that we have used for postemployment benefits is an asset-based rate. It's a long-term expected earnings rate for pensions, plan assets. Another problem we had was how to apply that notion with OPEB, because most of the OPEB plans are not funded. The Board ended up concluding the discount rate should be based on the assets that would be expected to be available to fund or pay the benefits—which could be partly employer assets.

I think a very important historical thing for the GASB has been to use a long-term rate and avoid the fluctuations in the liability that could result from using a current rate. We do understand from some of the respondents that this may be almost an unworkable method for the partially funded plans to even know what proportion of the liabilities would be expected to be funded and, therefore, to come up with a rate. But the implications of this standard would be that the discount rate assumption should be relatively stable over time, and that the discount rate for unfunded plans may tend to be lower because the investment options are more limited.

There would be six allowable actuarial cost methods that the Board has deemed to be appropriate for accrual accounting purposes, the same as for pensions. The measurement of an employer's annual OPEB cost would be based on the annual required contribution (ARC) of the employer. It's the same as the ARC for pensions. It's a computed number based on actuarial valuation in accordance with the parameters, regardless of the amount paid. It would include the normal cost and a provision to amortize the total unfunded actuarial liabilities or the funded excess over a period not to exceed 30 years. The methods of amortization, as with pensions, are flexible in that you could do the amortization as one lump sum or as components having different periods. You could use level dollar or level percentage of payroll amortization and could amortize on a closed or open basis.

In the accrual basis financial statements, which would be your government-wide statements and your enterprise fund statements, also fiduciary fund statements, employers would report OPEB expense equal to the annual pension costs regardless of how much was paid for the period (actually contributed). The cumulative difference between the amounts expensed and the amounts actually contributed would create a liability called the net OPEB obligation. That would appear on the statement of net assets.

In the governmental fund financial statements there's really no change. Those statements are on the modified accrual basis. They measure expenditures rather than expenses. It's really the same as before. One thing that the Board has done that we did not do for pensions, because it didn't seem necessary for pensions, is to clarify criteria for employer contributions. We're saying that an employer would be deemed to have contributed only if they had paid benefits, or paid premiums, or made an irrevocable transfer of assets to a dedicated OPEB trust. The point of that is to say that net assets that an employer has set aside within their own governmental funds or in a proprietary fund type of the employer for future OPEB payments would still be considered employer assets and would not be considered to have been contributed. When you measure the funded status of the plan, those are not plan assets.

The note-disclosure requirements for OPEB employers would be very similar to those for pension employers. For example, requirements would include plan description, funding policy, the amount, and the components of the annual cost, the amount actually contributed, the change in the net pension or OPEB obligation, and the expense of annual costs that were contributed. However, the Board has made modifications from the pension disclosure requirements where we felt it was necessary to reflect differences between pensions and OPEB. For example, because most OPEB plans are not funded currently, the Board was much more concerned with making sure that users of financial statements could get information about the funded status of the plan. Accordingly, they have elevated the current funded status information to a note-disclosure requirement.

There would also be some expanded explanatory disclosures about the actuarial valuation process and the assumptions and methods that were used. That is an attempt to make this information understandable or accessible to others and, I think, partly to caution against people taking these numbers as being precise or unchangeable measures. Employers would also be required to provide, as required, supplementary information such as multiyear trend information about funding progress. This would be the same information as in the funded status note, but it would provide information for multiple years so that people could assess trends. That information would include the actuarial accrued liability, the actuarial value of plan assets, which is usually a market-related value, and the unfunded actuarial liability, the funded ratio, and some other information.

Another new requirement has to do with employers that choose to use the aggregate actuarial cost method. This also relates to concern about users being able to assess the funding progress. Those employers would be required to prepare a schedule of funding progress using the entry age actuarial cost method as a surrogate. Some people have asked, why do you even allow the method? There was some discussion of that, but I think it was just a matter of consistency with the pension standards. However, we're concerned about the possibility that employers that are not funding at all or have never had an actuarial valuation would choose aggregate just for accounting purposes and not also use it to fund. That combination would potentially frustrate efforts for people to know where they were in funding the plan.

Implementation of the standards would be prospective, that is, employers would start with a net OPEB obligation of zero. Implementation would be staggered in three phases. Partly that was as a result of concerns expressed from the actuarial profession that we're suddenly proposing to bring on thousands of valuations that have never been in the market before and that it might take some time to absorb that increase in demand.

The plan-reporting requirements have to do with reporting custody for plan assets. We still have a couple of things to work out there. We want to try to avoid situations where the employer is saying we're not responsible for actuarial information, and the plan is saying that because we're just passively collecting and remitting premiums and don't have a formal trust, we don't think we're responsible either. We're going to close that door one way or the other.

One other new requirement has to do with cost-sharing employers, and, again, this is a concern about a worst-case practice scenario that could develop where you have a bunch of pay-as-you-go governments, and they band together and form a pay-as-you-go cost-sharing plan and try to finagle the thing where they don't have to provide actuarial information. If the plan does not provide GAAP financial reporting, including schedule of funding progress and schedule of employer contributions, then the employers would be required to present that information.

Currently, as I said in the beginning, we're past the issuance of exposure drafts. We had a user forum with some financial analysts in conjunction with the NFMA conference in Chicago and a couple of public hearings, and we have about three more GASB Board meetings in which we're scheduled to go through a series of issues based on respondent comments and try to get final statements out in December. The employer standard would be effective for periods beginning after June 15, 2006, 2007 and 2008, depending on the total revenues of the government. For plans, the plan reporting standard would be effective in the year preceding the effective date for the largest employer in that plan.

MR. JOHN BARTEL: I'm going to talk about some of the things that Karl talked about. I'm also going to talk about some definition of terms that are a little bit foreign to actuaries who have not done much work in the public-sector area. For those of you who have done a lot of FAS 106 work, it will be easy to transition this terminology once you get it. If you've done FAS 106 work, not a lot of public-sector work, it might be a little bit interesting, and it might take you a little while to work into that process.

Let's go back to a couple of things that Karl said. The Board position is it's a promise to exchange deferred compensation for employees' current service, regardless of form, whether written or oral, and regardless of the means or timing of funding. That is particularly important. The costs and obligations should be measured on an accrual basis. If you take a step back for a moment and think about this from a generational taxpayer point of view, that's exactly what's going on. The idea is that the GASB is really saying you need to recognize the value of benefits as employees render service. That's really all that's going on. What the GASB is doing is turning over that statement to the actuaries and saying now it's your job. It's your job to allocate benefits that are being earned as people render service.

There really are two key items that are going into the financial statement. There's an OPEB expense, or an annual OPEB cost, and then the net OPEB obligation. Let's talk a little bit about those, but before we do, the basis of those is, as Karl said, the funding methodology. With the funding methodology, you have to calculate an annual required contribution. That is the exact same concept as under Statement 27, where you've got a normal cost, and you've got an amortization of an unfunded liability, a fair amount of leeway, and you can calculate the amortization component as a level dollar amount, a level percentage of pay. You can do it with an open or a closed group methodology.

Karl talked about the six funding methods. Let's talk very briefly about the difference in the amortization method. This is meant to be overly simplistic. If you think of your home mortgage as a 30-year constant payment amount, and the FAS 106 approach as a constant principal payment, with the GASB approach, most public-sector entities pay their unfunded liability as a constant percentage of pay. Depending upon the increase in future pay, you end up with a much lower amortization payment under that approach than you do under either of the other two. The payment patterns, of course, are pretty interesting.

Higher dollar amounts in the future for the GASB approach, level percentage of pay approach, lower dollar payments in the future under the FASB approach and a level dollar under your standard home mortgage. This is a key point, that as you speak to clients about this, not all of them fully understand and appreciate that if you amortize your unfunded liability as a percentage of pay, depending upon what your underlying assumptions are (payment periods much beyond 17 years or somewhere in that neighborhood), you've got a negative amortization. You're not paying down your unfunded liability. If you think about this for a second, if you have a rolling 30-year amortization as a level percentage of pay, you're not really paying down your unfunded liability. That is a concept I think not all public-sector entities fully understand and appreciate.

Generally speaking, actuaries need to follow the Actuarial Standards of Practice for retiree health-care valuation. You need to look at the current substantive plan. Karl talked about this. Really, unless and until the plan has been changed and communicated to employees, you really need to value the underlying substantive plan, which is the exact same concept as FAS 106. It precludes anticipating plan termination or future plan changes increase or decrease in benefits, if you will, unless, of course, there's a pattern to providing those.

I think the discount rate is a particularly important issue. As Karl said, most public-sector entities have really not prefunded. Most public-sector entities are restricted in terms of what they can invest in. If you are looking to set your discount rate to the underlying source of the funding, what you're really looking for is that public sector's general fund or employee benefit fund. You're probably looking at discount rates on a long-term basis in the neighborhood of 4.5 or 5 percent for unfunded plans. If you do have a plan prefunded in a trust, that is a different issue. When you use a trust, that gets to the whole argument of the actuarial controversy, if you will, but certainly it is a different issue in setting that discount rate. Actuarial value of assets must be, of course, market related. The assumptions, other than the discount rate, really should be consistent with the underlying pension plan assumptions for the similar group.

Let's talk about what that net OPEB obligation is. It is the historical difference between what the plan sponsor should have contributed and what they actually did contribute. If you've got a funded plan, and if the plan sponsor has always put into the trust the annual required contribution, then the net OPEB obligation or annual OPEB cost will always equal the actual contributions. The net OPEB obligation, that historical difference, will equal zero.

Under FAS 106 we had a look-back as to what maybe we should have done. Under the GASB OPEB ED it's a go-forward basis. The presumption is that in year 1 of adoption of the standard the annual required contribution or the annual OPEB cost equals the annual required contribution. You start out with a net OPEB obligation of zero. As you go merrily along your way, if the public-sector entity is not contributing into the trust, the ARC is adjusted for interest on the net OPEB obligation and the amortization of what has not been contributed.

For those of you who are familiar with the GASB 34 standard, public-sector entities were really divided into three categories, Phase I, Phase II and Phase III. Phase I is for public-sector entities with $100 million of revenue and more. Those were the early implementers, and those are for this standard fiscal years beginning after June 15, 2006. A year later will be for Phase II, and a year later still for Phase III.

I have my very rough rule-of-thumb of OPEB valuations that we have done to wake up directors of finance and human-resource directors as to the magnitude of these issues. We have a little table that says if we take the actuarial information and translate it either into a percent of pay or a percent of an annual general fund budget, how big is this issue? How big are these numbers? Is it bigger than a breadbox? Is it bigger than city hall? What the heck is it?

What we really have done is come up with three very simple different plan designs. For Plan Design 1, you have a public-sector entity that provides full medical coverage for the retiree and the spouse with, arguably, no assets or no prefunding whatsoever. The discount rate is about a 5 percent discount rate. An example would have an annual required contribution, 28 percent of pay, with the actuarial liability or unfunded actuarial liability or unaccrued actuarial liability of almost 200 percent of pay. This is going to vary a lot from one group to the next. The percentages would probably be higher for a rural area. The benefit promise may, in fact, be very similar, but the pay level would be much lower. And then 1(b) happens to be an entity that prefunds their obligation, setting that aside, you can see, using—if I'm remembering right—a 7 percent discount rate.

The annual required contribution in the example drops from 28 down to 17, and the actuarial liability or unfunded actuarial liability, 125–126 percent of pay. As a very rough comparison, if you look at line item 3—this actually, for those of you who are familiar with California law—if you participate in the California Public Employees' Retirement System (CalPERS) health-care system, there is a minimum dollar amount that an employer must subsidize retiree health-care benefits. It starts out at $16 a month, then it increases by law in several years to $97 a month, no other subsidy whatsoever.

That, by contrast with item 1(a) in particular, you're looking at an ARC that is roughly 2 percent of pay. It is modest. An actuarial liability that's about 20 percent of pay, and line item 2(a) and 2(b), similar to items 1(a) and (b), except that the benefits are capped, and this particular benefit happens to be capped at $450 a month. Item 2(a) shows no increase in the future cap; 2(b) shows the increase in the future cap. So I'm not suggesting you ought to use these for your clients. I'm suggesting that these are samples that we have kind of come up with to understand, if you will, the magnitude of the problem. This is the issue that kind of gets people's attention: are the ARCs as a percentage of pay approaching, and in some cases exceeding, retirement plan contribution rates and, in particular, those same percentages of these agencies' general fund budget. It ends up being very large numbers by any stretch of the imagination.

MR. WILLIAM REIMERT: My portion of the presentation will address (1) a couple of issues that the Academy of Actuaries has raised concerns about, (2) some wrinkles that I think you might want to think about that you might not have had to deal with before and (3) the comment letters that have been submitted to the

GASB. Karl provided me with copies of the comment letters. I went through them and picked out several I'd like to share with you. They're not carefully chosen to be perfectly representative. I'm not even going to identify people by name because by taking their comments out of context the excerpts may not actually fairly represent the writer's views.

The Academy has raised some concerns with the Board. Actually, these concerns were raised before the Board issued the exposure drafts. The first one dealt with the scope of the proposed standard. Karl mentioned this already: the implicit rate subsidies to retirees that can result from the participation in the plan with active employees. If a plan covers both actives and retirees and charges both actives and retirees the same rate, employers are not required to account for that as OPEB if the employer does not otherwise contribute to the cost of the benefits. There is a requirement, though, that if the employer takes advantage of that implicit rate subsidy to avoid accounting for it, at least the employer will have to disclose that fact and provide some explanation about what's going on with the plan.

I thought it was interesting in the exposure draft in the alternative views section that one of the Board members had addressed this issue in particular. He thought that this implicit rate subsidy exemption from the scope should be allowed only if the average premium rate for the entire group was not affected by the inclusion of retirees. If there was a calculation showing that active employees have a significantly lower cost than the retirees, then this exemption should not be allowed. You can see a copy of the Academy's comments if you go to the Academy Web site. It's posted there for your information.

The other area where, as you might guess, some comments were received was the proposed alternative measurement method. As Karl mentioned, it applies only to employers with fewer than a hundred plan members. In this context plan members include active employees as well as terminated employees who may have rights to a deferred commencement of these health insurance benefits as well as retirees and beneficiaries who currently have coverage. What the alternative method really allows is for employers to do the calculations without having to comply with all the requirements of Actuarial Standard of Practice (ASOP) 6. If an employer opts to use this alternative method, the employer would have to disclose that it was used and disclose the source and the basis for the significant assumptions.

The proposed alternative method came about because of the Board's concern regarding the cost-benefit relationship of applying the standard for small OPEB plans. The goal was to develop an alternative method that would allow nonspecialists, in this case nonactuaries, to apply this method.

Again, there was an alternative view. This was the same Board member, if I remember correctly, and he thought that rather than specifying a single methodology, the proposed standard should more broadly permit the use of an alternative measurement method provided the estimated expense, liability and related information are reasonably expected to not differ materially from the application of an actuarial valuation. This Board member believes that the responsibility for justifying the use of an alternative measurement method should be placed on the employer rather than actually laying out a method the way the exposure draft does. As I mentioned earlier, there's a comment letter from the Academy addressing this issue on the Academy Web site.

Even though this is a method that's intended for nonspecialists to provide, it seems to me that some employers might, in fact, come to an actuary and ask the actuary to apply the alternative method or ask the actuary to, in fact, apply something else that doesn't comply with ASOP 6. I just want to raise that idea as something that you might want to think about if you're going to be working in this area. You may want to think through in advance how you'll respond to such a request.

For those of you who haven't tried to apply an entry age normal cost method in the context of OPEB benefits or, in particular, retiree health insurance benefits, there is a new wrinkle you'll need to address. Under an entry age method, you have to be able to go from the current time back to somebody's entry into the plan and figure out what would have been the present value of, in FAS 106 jargon, their expected postretirement benefit obligation at entry age.

If you have an active employee who is already eligible to retire, that means they could have retired one, two, five, maybe even 10 years ago and started drawing OPEB benefits. To calculate an entry age normal cost, you have to be able to take current per capita costs and move them backward in time. You might want to think about what assumptions you're going to make in doing that.

If you just take actual trend as it developed over the last five or 10 years, however far backwards in time you have to go, effectively what you're going to be doing is, to the extent the trend recently has been high, holding down the normal cost. To the extent the trend has been low, you'll be increasing the entry age normal cost. You might want to think about how you want to project health costs backward in time.

An approach that I've done is to go to my ultimate trend assumption and apply that to move the health costs backwards in time. I think I'm getting a stable and a sensible normal cost by doing that. My primary purpose in the presentation is to raise the issue. This is something that you need address if you're going to be using an entry age method.

FROM THE FLOOR: You would use that ongoing, not just the first year that you apply this?

MR. REIMERT: If this year I'm using an ultimate trend of five, and next year it goes up to six or four, next year I'd imputing that new ultimate trend assumption to develop the prior history of health costs used in the entry age calculation.

FROM THE FLOOR: If you were doing a valuation a year earlier, you would have had a higher trend assumption than last year. Let's say your ultimate is 5 percent, but in going back one year ago the valuation of your first-year trend was maybe 12 percent. The valuation when you started working your way down last year was five; that would give you a loss.

MR. REIMERT: I would just sort of call timeout. I don't think this exposure draft is likely to apply to a plan where Internal Revenue Code 412 applies.

FROM THE FLOOR: (Inaudible question.)

MR. REIMERT: It sounds like you don't like the method I use. I was not trying to say that this is the only correct method everybody ought to use, although I'm very comfortable that the method I use makes sense. If we wanted to debate it, I'd defend what I'm doing. All I'm trying to do is raise the point, if you're going to use entry age normal, think through how you want to take per capita costs backwards in time.

This can be important because I know at least one major city where they provide these benefits to anybody who draws a pension. There's a very long period of time you'd need to project health costs backwards if you did an entry age normal calculation in that context. You have to go back to people's first vesting dates, not even their first date when they were eligible to early retire. It's an issue you have to think about. That is really the point of my raising it.

I have a bunch of comments that I'd just like to read verbatim from the comment letters that came in. I'll start with just some general comments.

I'll start off on a general comment from a finance officer: *Strongly support the proposed standards and feel it is long overdue for governments to be required to account and report their government's liability for postemployment benefits.*

From a finance officer: *We strongly support the alternative measurement method for smaller OPEB plans and employers. First, we urge that the threshold be raised from the current 100 participants to a minimum of 200 participants. Second, we believe it should be possible for the Board to provide an even simpler alternative measurement method.*

From a state official: *Our opinion is that this proposed statement of governmental accounting standards would provide little or no value to the reader and would impose a tremendous burden.*

From a labor organization: *These additional costs could also trigger state law spending limits, thus creating additional pressure to cut or terminate retiree health benefits.*

From a different labor organization: *Doubling up the cost of retiree medical benefits by requiring these governmental employers to recognize both the cost of current retirees and the cost of future retirees will artificially trigger state law constraints on spending. This premature recognition of retiree liabilities will force many responsible jurisdictions to cut or completely discontinue retiree medical benefits.*

From a state retirement system: *The proposed standards would likely cause a decline in health-care and other postemployment or postretirement benefits for governmental employees and retirees.*

From an individual citizen: *Until GASB requires direct balance sheet reporting of the unfunded actuarially accrued liability, the public will continue to be misled about the nature and costs of defined benefit pension and OPEB plans. Without such a requirement, politicians will continue "balancing their budgets on the backs of babies."*

From some accountants*: We're concerned with the overall complexity of the exposure drafts resulting largely from terminology that was difficult to understand.*

Another comment from accountants: *Management's discussion and analysis* [that section of an employer's financial statement] *requirements should be revised to specifically require discussion of the unfunded actuarial accrued liability and funding progress as well as the government's OPEB funding policy.*

Now, we'll change subjects to the implicit rate subsidies, which, as I mentioned earlier, the Academy had commented about, and that Karl mentioned in his presentation:

From a plan administration: *We hesitantly agree with the Board's proposal to exempt employers from reporting implicit rate subsidies when the requirements of Paragraph 6(a) are met. It is difficult to support the exemptions from an accrual purist's perspective. The costs associated with the implicit rate subsidy are clearly related to earlier periods. However, we essentially agree with the Board's cost benefit analysis.*

From a finance officer: *We like the fact that GASB weighed the cost benefit of the issue, and we like how it provides some simplification. However, we are concerned that this exemption will lead to manipulation.*

From an actuary: *An alternative that I would propose would be to ignore the implicit rate subsidy and plans that are fully insured because small employers are invariably fully insured. This precision would accomplish your objective of simplifying the valuation process for smaller employers (as you attempt to do with the alternative measurement method), and it would avoid having larger employers ignore significant liability by ignoring the implicit rate subsidy.*

In terms of comments on the timing and frequency of actuarial valuations:

From an accountant: *We agree with the frequency of valuations. However, the fiscal reality is that most large governments will probably value OPEB annually, similar to pension valuations to have consistent budgeting for the administrative costs of calculation.*

Another one from an accountant: *We agree that the maximum interval between actuarial valuations for OPEB plans that have fewer than 200 members should be extended to three years unless significant plan changes have occurred.*

From accountants: *In our opinion the Board should stay within the requirements of GASB 25 and 27,* [and] *the plans be valued at least biennially.*

Another one from an accountant: *Our proposal is that an actuarial study group should be required once every three years, only when there are 500 or more members in the plan.*

Those comments are all over the board on how often these have to be done. The comments are just making Karl's job and the Board's job so much easier resolving this. As far as the parameters as a whole, and, again, the parameters are setting the actuarial methods, the actuarial assumptions and amortization periods. That's really what the parameters are referring to.

From a labor organization: *Grandfather current retirees and near-retirees from the new standard. Rather than let the proposed OPEB accounting rule changes be used to punish current and soon-to-be-retirees, GASB should provide a longer transition period to a new method that would recognize current economic conditions and the time needed to prefund a meaningful benefit for future retirees.* I think 10 other individual people said that verbatim. The substantive plan is the basis for projections.

From an accountant: *Auditors cannot be expected to rely on plan changes that are not documented in writing. We recommend that the definition be modified to include only plan changes that are in writing, including memorandums of understanding and union contracts.*

From a labor organization: *We recommend that GASB alter the standards to allow expected future plan changes and expected future limits on plan sponsor costs to be included in the terms of an OPEB plan as understood by the plan sponsor and plan members.*

From a system administrator: *The substantive plan does not address plans whose contributions are limited by law. In my state contributions to the health-care fund are made by the employer. Employee and employer contributions cannot exceed a percentage defined in statute. We are striving to provide access to quality health* *care needed by our retirees over a rolling 10-year period. And yet a different system administrator said our plan will continue to be modified to the extent necessary to keep health-care expenses within our available funding means. We believe that the circumstances related to the determination of the substantive plan are so diverse that GASB needs to provide more latitude to plan sponsors than is currently envisioned in the exposure draft. Furthermore, we are greatly concerned that the disclosure of substantive plan liabilities that are in excess of available funding may eventually be legally construed as a promise to continue paying benefits indefinitely, even though the plan sponsor has established a documented history of decisive actions coupled with written and verbal statements to the contrary.*

On actuarial assumptions, from two system administrators: *We encourage GASB to explicitly permit actuaries to use professional judgment in establishing liabilities for nonstatutory required OPEB benefits, even when those judgments deviate from practices that would otherwise be required from ASOP 6 and possible other actuarial standards.*

From an actuary: *I encourage the Board to modify the standard as follows: (1) Require employers to account for the projected cash cost for current and future retirees based on the current per capita health-care cost, i.e., exclude projected future health-care cost increases. (2) Add a component to the annual required contribution to account for the actual increase or decrease in liability due to changes in per capita costs. Thus in subsequent years the employers would account for historical health-care cost changes. In the future the Board could modify the standard to include an allowance for health-care inflation, at which time the change would be from one accrual accounting approach to another. By limiting the initial change employers will have time to absorb the cost increase associated with moving from current cash accounting to current accrual accounting.*

It was interesting, I think, as Karl mentioned, on balance there were more people voting in favor of continuing with the alternative measurement method, but there were a lot of votes on both sides. It was interesting to see the comments for the people who were opposed to it, and those comments—at least my summary was—they came from people like plan finance officers, plan sponsors, auditors and actuaries. The negative comments were that the method was too difficult. They felt outside help would still be required, and nonexperts are likely to apply it incorrectly.

FROM THE FLOOR: (Question regarding implicit rate subsidy.)

MR. JOHNSON: People will begin to try to structure the way they state the premiums in order to get through the loophole. I totally agree with you. I think it would be unfortunate to create a situation where decisions get made for that reason.

FROM THE FLOOR: (Inaudible question.)

MR. JOHNSON I think since receipt of the comment letters, and particularly the Academy's response to the exposure drafts, there is some movement on the Board. Right now this is very close. I think we're near even division of the Board right now, whereas before we were not. There has been some movement that could go either way—I mean that exemption could be pulled or not. We will have a very interesting discussion of that, I believe, in July. Actually on the plane going home I've got a notepad, and I'm going to start framing that issue. I'm going to try to do it without using the term implicit rate subsidy because I think it has unfortunate connotations that this is something that in some sense is not real or that's concocted by actuaries and some accountants and somehow is not a real thing. I think I can frame the issue in another way. This proposal in the exposure drafts is an anomaly. It's not even consistent with our basic standard.

FROM THE FLOOR: (Inaudible question.)

MR. JOHNSON: Their suggestion is to allow employees, once they had, say, 20 years of service or people that were retired and receiving the benefits to continue to be accounted for.

FROM THE FLOOR: (Inaudible question.)

MR. JOHNSON: In terms of the auditors and things that are going on in that profession, it probably could not be done by the auditor, but it could be done by another CPA firm. You could have a staff accountant that did these for clients. It might be sort of a niche thing that somebody might take on.

MR. BARTEL: Or what you might have is a director of finance doing it.

FROM THE FLOOR: (Inaudible question.)

MR. JOHNSON: Are there very many cases in which it would be difficult to get that from the insurance company, where they would not provide it? We've heard both.

FROM THE FLOOR: (Inaudible question.)

MR. JOHNSON: If you can't get that, would you fall back on more general information that your firm had about relationships between claims costs for different ages?

FROM THE FLOOR: (Inaudible question.)

MR. JOHNSON: I think in the illustrations of disclosures that we prepared for the exposure drafts there is a discussion where we introduced the term ARC. It's an amount that if contributed regularly would cover the normal cost and is projected to amortize the unfunded actuarial liability over a period not to exceed 30 years. That's generally the way we tried to explain it. I don't know if that's the best way to explain that or not. By having the word required, some people have construed that there was some legal requirement, but actually their legal requirement may be some fixed percentage of payroll or some other basis entirely. It's not a requirement as such. It's just a calculated amount that it would take to fund the thing over a certain period.

FROM THE FLOOR: What's the meaning of this information if agencies don't prefund?

MR. BARTEL: I don't think we know the answer to that. I don't think we're going to know the answer to that for four, five, six years. Having said that, though, I think that the primary implication of this is in the bond-rating agencies. If you have two different entities that are identical in every way, and one has a large footnote disclosure of an unfunded OPEB obligation, and another one does not, then it is hard to imagine the bond rating agencies aren't going to take that into account. I think that's the big issue.

MR. REIMERT: This issue came up when FAS was coming out, my recollection is that the bond rating companies said they didn't care about FAS 106. They may have changed their tune in the decade or whatever since FAS 106 came out, but at the time they said that their concerns were about the ability of cash flow to cover the repayment on the bonds. I'm not trying to argue how they would view it today.

FROM THE FLOOR: (Inaudible question.)

MR. JOHNSON: We had a meeting with some of the financial analysts from the rating services as well as representing investors in Chicago, May 1, 2003. They were generally very supportive of the standard. I think they will welcome this. They felt like that there was a lot of uncertainty or risk about the effects of these benefits. They're going through that same issue as to how to look at postemployment health-care liabilities in comparison to pension liabilities. The GASB basically saw this the same as the FASB did. For the nonguaranteed benefits, even though the employer may have the stated unilateral right to withdraw the benefits, that in practical terms if these were given as compensation for services, then they become an expected part of the compensation package, It's going to be difficult for governments to withdraw from them without giving something in their place or suffering some cost in some fashion.