

GASB 45 for School Attorneys

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Why should school attorneys be interested in GASB 45?

In the next few years, school attorneys will be forced to deal with GASB 45 and its impact on school district collective bargaining agreements, budgets, credit ratings, and disclosure for bond financings. Beginning next year, many larger districts will be required to recognize the long-term costs of retiree healthcare benefits in their financial statements. This article is intended to provide school attorneys with a broad overview of GASB 45 and an explanation of its impact on school district clients.

What is GASB?

The Governmental Accounting Standards Board ("GASB") is a national accounting standards board established to set the standards of financial accounting and reporting for state and local governmental entities. Its standards guide the preparation of external financial reports of those entities. GASB's mission is to establish and improve standards of state and local governmental accounting and financial reporting that will result in useful information for users of financial reports and guide and educate the public, including issuers, auditor, and users of those financial reports. GASB is recognized by the U.S. Securities and Exchange Commission ("SEC") as the source of generally accepted accounting principles for state and local governments.

Although GASB does not have the authority to enforce compliance with the standards that it promulgates, independent auditors are required to note any departures from GASB standards when they express an opinion on financial reports in accordance with generally

accepted accounting principles. Moreover, legislation in many states requires compliance with GASB standards, and governments are expected to prepare financial statements in accordance with those standards when they issue bonds in the public markets.

What is GASB 45?

In June 2004, GASB issued Statement No. 45, Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions. This accounting standard was issued to improve the financial transparency of the cost of other post employment benefits. Other post employment benefits other than pensions (“OPEB”) generally take the form of health insurance and dental, vision, prescription, or other healthcare benefits provided to eligible retirees (in some cases their beneficiaries too). OPEB may also include some types of life insurance, legal services, and other benefits.

Why did GASB issue new standards for OPEB?

GASB 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 OPEB to their employees as part of the compensation for services rendered. Health care costs have clearly outpaced the rate of inflation over the past two decades, resulting in post employment healthcare benefits that comprise a relatively greater portion of state and local government budgets. Since post employment healthcare benefits are the single largest component of OPEB, these costs have become a significant financial commitment to the state and local governments that offer them.

How was OPEB accounting and financial reporting done prior to GASB 45?

Prior to GASB 45, state and local governments typically followed the “pay-as-you-go” accounting approach in which the cost of benefits was not reported on financial statements until

after employees retire. This accounting approach significantly under reports the district's real cost of OPEB.

What does GASB 45 require?

GASB 45 requires an employer to report expenses and specific information about OPEB on its financial statement and footnotes. In order to comply with GASB 45, employers with 100 members or more need to hire a qualified actuary to perform the actuarial valuation. The purpose of the actuarial valuation is to determine the employer's annual required contribution ("ARC"), unfunded actuarial accrued liability ("UAAL"), actuarial value of assets, and other related information.

In order to comply with the GASB rules, the following requirements must be met:

1. Valuations must be performed every two years for OPEB plans with more than 200 members and at least every three years for plans with fewer than 200 members;
2. The actuary can choose from six different actuarial methods: entry age, projected unit credit, attained age, frozen entry age, frozen attained age, and aggregate. The two most commonly used actuarial methods are entry age and projected unit credit;
3. Actuarial assumptions must conform to the Standards of Actuarial Practice;
4. The maximum period for amortizing the unfunded actuarial liability is 30 years;
5. The investment return assumption should reflect the long-term yield on investments expected to fund the benefit; and
6. The actuarial value of assets must be a market-related measure, either a current market value or market-smoothing method.

For financial reporting purposes, the districts need to report two key OPEB measures:

1. The ARC (also referred to as the “OPEB cost”) calculated by an actuary. The ARC is the amount that will be recorded as the district’s expense on its annual financial statements.
2. The “net OPEB obligation” is the difference between the OPEB cost and actual annual employer contribution. The net OPEB obligation will determine the OPEB liability recorded on the district’s financial statements. To count against the net OPEB obligation, the district’s contribution must be funded into a qualified trust.

In addition, districts are required to include the following information in the notes to the financial statements.

- a. Plan description, including: name of the plan, trust administrator, brief description of the types of benefits, and the authority under which benefit provisions are established.
- b. Funding policy, including authority under which the obligations of the plan members and employer are established or may be amended, and required contribution rates of the plan members and employer.
- c. The current year annual OPEB cost and the dollar amount of contributions made.

The above information represents a brief summary as well as a simplification of GASB 45 requirements and guidelines. GASB 45 is a very complicated standard that requires the expertise of an actuary and certified public accountant (“CPA”). School districts should hire a qualified actuary to perform the actuarial valuation, and hire a qualified CPA to assist with the accounting and disclosure requirements in accordance with GASB 45.

Are districts required to pre-fund their OPEB liability?

GASB 45 does not require the OPEB to be pre-funded or funds to be held in a trust. However, there are significant advantages for districts in doing both. Certain state laws permit assets held in a retiree health care trust to be invested in equity investments under the “prudent

person rule.” This rule allows the trust to diversify the investments of the funds so as to minimize the risk of loss and to maximize the rate of returns, unless under the circumstances it is clearly not prudent to do so.

To be considered compliant under GASB 45, a trust must include three significant requirements in order for assets to be considered plan assets. First, the employer contributions to the trust must be irrevocable. Second, the assets must be dedicated to providing benefits to retirees and their beneficiaries. Third, the assets must be legally protected from the employer’s creditors. If these conditions are satisfied, employer contributions can offset the OPEB liabilities in the financial statements, and the actuary can use a higher investment rate when calculating the ARC and OPEB liabilities. The higher the investment rate used in the actuarial valuation, the lower the ARC and total OPEB liability will be. As a general rule of thumb, a 1% difference in investment rate will lower the OPEB liability by 15% to 20%.

In addition to meeting the GASB 45 requirements, other characteristics are desirable when selecting a trust funding vehicle. The employer should choose a trust that has the least amount of administrative requirements and is the easiest to implement. The trust chosen should allow for assets to be invested under the prudent person rule while protecting assets from creditors. Most importantly, the district should choose a trust that will allow assets to earn tax exempt investment income, while ensuring distributions of retiree benefits to be tax free to the retiree and/or beneficiary.

Districts have several trust vehicles to choose from, including Internal Revenue Code (“IRC”) Section 401(h) trusts, voluntary employee benefit association (“VEBA”) trusts, and IRC Section 115 trusts. There are several advantages and disadvantages of each of the trusts. It is advised that the district perform diligent research on what trust vehicle is the right choice for it.

When does GASB 45 become effective?

GASB 45 must be implemented by employers in three phases based on their total revenue as of June 30, 1999, as follows:

- Phase 1 (2007-08 fiscal year): public agencies with total revenue of \$100 million or more must comply in the fiscal year after December 15, 2006.
- Phase 2 (2008-09 fiscal year): public agencies with annual revenue between \$10 million and \$100 million must comply in the fiscal year after December 15, 2007.
- Phase 3 (2009-10 fiscal year): public agencies with annual revenue less than \$10 million must comply in the fiscal year after December 15, 2008.

What are the most common misconceptions about GASB 45?

1. That it requires governments to fund OPEB. GASB 45 does not require funding the OPEB liability; it only establishes the standards for accounting and financial reporting.
2. That it requires immediate reporting of a financial-statement liability for the entire unfunded actuarial accrued liability. GASB 45 does not require immediate recognition of the UAAL as a financial statement liability.
3. The employer has no GASB 45 liability.
 - a. Employers may have an “implicit rate subsidy.” In health insurance plans where a government’s retirees and current employees are insured as a group, the premiums paid by the retirees may be lower than they would be if the retirees were insured separately. In this case, the employer would have a GASB 45 liability based on the implicit rate subsidy.
 - b. Employers may have a liability based on the “substantive plan.” Under the GASB rules, the actuary must perform the actuarial valuation based on a substantive plan

to determine the OPEB liability. The substantive plan is not the underlying insurance plan or the provisions in collective bargaining agreements. It is the plan “as understood by the employer and plan members” at the time of valuation, as documented in written communications, including established patterns of cost sharing between the employer and employees.

4. The OPEB liability is not a significant cost or liability. Upon obtaining a GASB 45 actuarial valuation performed by an actuary, many employers are surprised that the OPEB liability is much higher than they anticipated.

What is the impact of GASB 45 on school attorneys?

Although GASB 45 will not take effect until fiscal year 2007-08, it will significantly impact districts’ collective bargaining negotiations, budget, credit rating, and disclosure for bond financings.

Collective Bargaining

In 1991, the Financial Accounting Standards Board (“FASB”) issued FASB No. 106. This is the public and private company accounting standard equivalent of GASB 45. According to the Kaiser/HRET Survey of Employer-Sponsored Health Benefits, the number of large employers offering retiree medical benefits dropped from 66% in 1988 to 36% in 2004,¹ and recently General Motors, IBM, and other large companies are further eliminating their OPEB.

Many private companies have realized that the healthcare benefits that were promised many years ago are no longer affordable or sustainable. As baby boomers retire in the near future, retired employees live longer, and costs of medical healthcare coverage continue to

¹ KAISER FAMILY FOUNDATION & HEALTH RESEARCH EDUCATIONAL TRUST, EMPLOYER HEALTH BENEFITS 2005 ANNUAL SURVEY 114 (2005), *available at* <http://www.kff.org/insurance/7315/index.cfm>.

increase, districts will need to make significant changes to the OPEB that they offer their employees.

School districts can learn from what has happened in the private industry. The cost of retirement benefits has made many of the largest companies less competitive as their cost to provide retiree benefits have continued to increase. It would be prudent to determine the accrued cost of the district's OPEB and to begin the conversations with employees, retirees, and other stakeholders to ensure the district's ability to provide reasonable, affordable, and sustainable retirement benefit into the distant future.

District Budgets

For those districts that offer OPEB to their retirees, the financial impact to the district's budget will be significant. The severity of the impact will depend on the required vesting periods and the level of retiree benefits. If a district has few restrictions on the vesting period to obtain the retiree benefits and provides lifetime health benefits to those retirees that meet the eligibility requirement, the district should not be surprised when the actuary reports a significant OPEB liability.

Actuaries who have experience in performing GASB 45 actuarial valuations have indicated that employers should expect the annual OPEB cost to be 3 to 10 times their pay-as-you-go amount. Thus, if a district's current year actual cash payment for retiree healthcare benefits is \$100,000, a district should anticipate that their OPEB cost will be anywhere from \$300,000 to \$1,000,000. The actuarially calculated OPEB cost will be dependent on the demographics of the district staff and retirees and the assumptions used in preparing the actuarial valuation. The majority of governmental entities have not pre-funded their OPEB liabilities, and this is likely to have severe budgeting consequences when GASB 45 becomes effective.

Credit Ratings

Three major rating agencies have issued reports of their position on GASB 45.

- Standard & Poor's Rating Agency ("S&P") has indicated that it will analyze any OPEB obligation in the same way that it currently evaluates pension obligations. As part of the overall OPEB liability analysis, S&P will include the implications of not only the total unfunded liability, but also how the annual required contribution is managed.²

- Fitch Rating's ("Fitch") credit focus in the early years will be on understanding each issuer's liability and its plans for addressing it. Fitch will also review an entity's reasoning in developing its plan. An absence of action taken to fund OPEB liabilities or otherwise manage them will be viewed as a negative rating factor.³

- Moody's Investor Service ("Moody's") indicates that the OPEB funding process will become a more visible factor in the credit rating process, similar to pension obligations.⁴

In sum, all the rating agencies have indicated that they view OPEB liabilities similar to pension obligations and will factor them into their assessment of a district's credit rating. Thus, a district's management of its OPEB liability will have a bearing on its credit rating.

Bond Disclosure Requirements

Martha Mahan Haines, Chief of the SEC Office of Municipal Securities, stated in the March 2, 2006 issue of the BOND BUYER⁵ that, "Issuers should include material information about OPEB in disclosure documents as soon as it is known, even if the final numbers are not yet available." She went on to say that "GASB's effective dates for inclusion of OPEB in financial

² STANDARD & POOR, *Reporting & Credit Implications of GASB 45 Statement on Other-Employment Benefits*, Dec. 1, 2004.

³ FITCH, *The Not So Golden Years*, June 22, 2005.

⁴ MOODY'S, *Other Post Employment Benefits (OPEB)*, July 2005.

⁵ www.bondbuyer.com/article.html?id=20060301K702ICZ&from=home

statements do not justify withholding material information from investors.” Thus, districts with a GASB 45 liability that issue public financings should closely review their disclosure requirements.

What Actions Should Districts and Attorneys Consider Now?

1. Educate yourself on GASB 45. If your district offers OPEB to retirees, educate yourself on GASB 45. This issue will have major budgetary, financial, and legal consequences in the near future.
2. Determine the substantive plan. Assemble your management team responsible for human resources, labor relations, and finance to fully understand the nature of the OPEB liability.
3. Be proactive. Recommend that your district hire a certified actuary to perform a GASB 45 compliant actuarial valuation to measure the district’s OPEB liability.
4. Understand the implications of pre-funding assets into an irrevocable trust. Research the pros and cons of a GASB 45 qualified trust.

CSBA and the GASB 45 Solutions Program (“Program”)

The California School Boards Association (CSBA) has developed a one-stop GASB 45 program to help California school districts and public agencies. The one-stop program helps districts obtain proposals from qualified actuaries to fund assets into a GASB 45 and Internal Revenue Service approved trust. After nearly two years of conducting research and assembling a team of professionals, CSBA established a multiple employer Internal Revenue Code Section 115 (“Section 115”) irrevocable trust. In February 2006, CSBA’s trust received a Private Letter Ruling (“PLR”) from the IRS that confirmed the trust was written in accordance with Section 115 and that assets invested in the trust could earn tax exempt investment income. The PLR that

CSBA received is one of the first in the country for a multiple employer Section 115 irrevocable trust related to retiree healthcare benefits.

CSBA decided to invest the time and resources in the Program after it surveyed its members. Of the 1,000 districts and county offices of education surveyed, CSBA received more than 600 responses back from its members. Of the 600 members that responded, more than 440 districts and county offices of education indicated that they offered OPEB to their retirees. CSBA estimates that more than 600 California districts and county offices of education offer OPEB to their retirees. For more information, go to <http://www.csba.org/ds/gasb45.htm>.

If you “Google” GASB 45, do not be surprised if the Program is the first item that appears as it is one of the most viewed sites on this subject. CSBA staff would be glad to talk to state school boards associations and others about CSBA’s GASB 45 Solutions Program. Call Martin Tokunaga or John Bukey (CSBA General Counsel) at (916) 371-4691. For additional resources on GASB 45 see the box below.

The following are additional useful resources about GASB 45:

CSBA’s GASB 45 Solutions Program, <http://www.csba.org/ds/gasb45.htm>

GOVERNMENTAL ACCOUNTING STANDARDS BOARD, OTHER POST EMPLOYMENT BENEFITS: A PLAIN LANGUAGE SUMMARY OF GASB STATEMENTS NO. 43 AND NO. 45, *available at* http://www.gasb.org/project_pages/opeb_summary.pdf

GOVERNMENTAL ACCOUNTING STANDARDS BOARD, GASB STATEMENT 45 ON OPEB ACCOUNTING BY GOVERNMENTS, A FEW BASIC QUESTIONS AND ANSWERS, *available at* http://www.gasb.org/project_pages/gasb_st45_basic_q&a.pdf