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GASB Statement No. 45

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...an overview of the new financial reporting standard issued by the Government Accounting Standards Board concerning postemployment benefits other than pensions

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March 2007

MTAS
Municipal Technical Advisory Service
In cooperation with the Tennessee Municipal League

THE UNIVERSITY of TENNESSEE

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The Municipal Technical Advisory Service (MTAS) was created in 1949 by the state legislature to enhance the quality of government in Tennessee municipalities. An agency of the University of Tennessee Institute for Public Service, MTAS works in cooperation with the Tennessee Municipal League and affiliated organizations to assist municipal officials.

By sharing information, responding to client requests, and anticipating the ever-changing municipal government environment, MTAS promotes better local government and helps cities develop and sustain effective management and leadership.

MTAS offers assistance in areas such as accounting and finance, administration and personnel, fire, public works, law, ordinance codification, and water and wastewater management. MTAS houses a comprehensive library and publishes scores of documents annually.

MTAS provides one copy of our publications free of charge to each Tennessee municipality, county and department of state and federal government. There is a $10 charge for additional copies of "GASB Statement No. 45."

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ACKNOWLEDGEMENT

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... an overview of the new financial reporting standard issued by the Government Accounting Standards Board concerning postemployment benefits other than pensions

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As an incentive to attract and retain qualified employees, state and local governments often augment the compensation packages they offer employees by including postemployment, or retirement, benefits. Postemployment benefits may include some type of retirement income plan and/or other noncash benefits, such as group insurance coverage.

Obviously, employee compensation packages must be funded by the organization offering them. Organizations fund current compensation liabilities for employees and retirees through annual appropriations. But how does the organization account today for liabilities for the benefits promised to retirees in the future?

Since 1984, the Government Accounting Standards Board (GASB) has shouldered the responsibility of establishing consistent financial reporting standards for state and local governments. In the past, GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, adopted reporting standards for state and local governments to account for the liability associated with government pension plans. With the phased implementation of Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, state and local governments will be required to formally recognize the full cost of retirement promises made to employees, in addition to pensions, related to their retirement.

The cost of retirement benefits continues to grow. Over the past few years, health costs have experienced double digit inflation, escalating the costs associated with promises of postemployment benefit plans other than pensions. The intent of this statement is to address and quantify the total amount of liability associated with employee retirement benefits accumulating with each passing year.

POSTEMPLOYMENT BENEFITS

An employer may offer postemployment benefits to its employees as part of their total compensation package as a reward for years of continuous service. These benefits are authorized in an agreement or policy that defines what the employer promises to provide a qualified retiring employee. Major categories of retirement benefits include retirement income – pensions and any other benefit as an integral part of a pension, such as healthcare or other group benefits.

Retirement Income

The most familiar type of retirement benefit is postemployment income derived from a pension. Pensions may be separated into three categories:

1. Defined contribution plan;
2. Defined benefit plan; and
3. Hybrid.

Although each type of plan provides for postemployment income, the structures are quite different, and, depending on which plan is chosen, the risk of funding retirement income may be with the employee or with the employer.

Defined Contribution Plan

Defined contribution plans focus on the input or contributions made by the employee and, perhaps, on behalf of the employee by the employer. When plan contributions and applicable interest earnings have been distributed, the plan has no further obligation to the retiree. The only retirement promise made to the employee by the employer is that the contributions made toward the employee's retirement, plus interest earned on the investment, will be returned to the employee upon retirement.

Under the defined contribution plan, the complete risk for postretirement income lies with the employee. Will the amount invested by the employee over time, plus the interest earned on the investment, provide enough money for retirement? Most employees do not have the expertise to plan for their income needs at retirement. They often employ the services of financial advisors who assist them in the process of investing for their retirement.

Defined Benefit Plan

A second type of employee retirement pension is the defined benefit plan. This type of pension plan is based on the employer's promise that future investment returns will be paid to the employee. Under this plan, the employer may or may not require the employee to make contributions. The focus of this plan is the guarantee that the employer will make payments to the employee from the time of retirement until the employee's death, regardless of the amount the employee has contributed to the plan. Some of these plans provide options to allow the surviving spouse of an employee to continue to receive payments throughout his or her life as well.

This pension type is a guarantee of retirement income to the employee that is usually based on a formula considering the employee's years of service and average annual compensation. In this case, the employer is assuming the full risk of the promise to provide the retiree's income. In order to determine the future financial exposure to the organization regarding this retirement income guarantee, an employer will hire an actuarial firm to calculate the cost of this retirement promise. Actuarial calculations estimate the cost of the retirement plan by factoring payroll projections, ages, and years of service for all employees of the organization as well as the rate of return on investment of present and future assets of the retirement fund.

Since the organization assumes the total risk for this type of employee pension, the employer typically makes annual deposits into a retirement trust fund in order to guarantee a source of funds for these future obligations.

Hybrid

The hybrid may be any combination of the defined contribution and defined benefit pension plans. Contributions are typically made to the plan each month. Options may include a guarantee from the employer of the rate of interest the employee will earn on the contributions, but there is no full retirement income guarantee.

IMPROVED FINANCIAL REPORTING

Due to the nature of the liability associated with retirement income, GASB established financial reporting standards regarding pensions with Statement No. 27. However, the costs of other postretirement benefits, such as group insurance benefits, have never been considered as an "accrued" liability.

As its budget is prepared each year, a government makes appropriation to fund the group-related benefits of its employees and, if applicable, the benefits of its retirees. If part of the employee's total compensation package includes group insurance benefits at retirement, where is the line item appropriation? Since the payment of this portion of the employee's compensation is not made until later, often many years later, the promise goes unfunded. Regardless of when the payment is actually made, the liability of the promise is accruing year by year at an ever-increasing cost.

Compensation related to benefits at retirement other than pensions are called other postemployment benefits (OPEBs) and are a part of the exchange of salaries and benefits for employee services rendered. Some of the exchange is used concurrent with the employee's service as payment of salary and health insurance benefits. OPEBs are the part of compensation taken later when the employee's services have ended.

The intent of GASB 45 is to account for the unused portion of compensation that has been promised to employees today for payment in the future. These costs of benefits should be accounted for when the promise is made, even if the payment is many years later.

SUMMARY OF GASB STATEMENT NO. 45

Measurement

When OPEBs are a portion of the total compensation earned by employees for services provided, employers that participate in single-employer or agent multiple-employer defined benefit OPEB plans must measure and disclose the annual OPEB cost. Because the OPEB compensation is earned but not paid out within the period, this liability must be measured and disclosed by using the accrual basis of accounting. For each year OPEBs are being earned, an amount will be added to the growing liability of the retirement plan. The annual OPEB cost equals the employer's annual required contribution (ARC) adjusted by any amount that the employer has under- or over-contributed to the retirement liability.

Annual required contribution (ARC) is the amount of liability calculated to represent the value of OPEBs earned by the employees in one year. The parameters by which the ARC is calculated include:

- The normal costs for the year;
- A component for amortization of the total unfunded actuarial accrued liabilities (or funded excess);
- Requirements for the frequency and timing of actuarial valuations; and
- Acceptable actuarial methods and assumptions.

State and local governments are required to have actuarial valuations. The timing of these valuations depends on the total number of participants in the plan. The definition of participants includes:

- Employees in active service;
- Terminated employees not receiving benefits; and
- Retired employees and beneficiaries currently receiving benefits.

For plans with 200 or more participants, biennial actuarial valuations are required. For plans with fewer than 200 participants, triennial actuarial valuations are required.

Projection of benefits should include all the benefits covered by the plan with consideration of the method by which the costs of the benefits are shared between the employer and the employee. The actuarial assumptions must be guided by applicable actuarial standards, including a healthcare cost trend rate for postemployment healthcare plans. The aim of the actuarial valuation is to project future cash outlays required for the level of benefits promised, discount projected benefits to their present value, and allocate the present value of benefits to periods using an actuarial cost method.

Alternate Measurement Method

A sole employer with a plan of fewer than 100 total plan members has the option of using a simplified alternate measurement method for determining ARC instead of obtaining actuarial valuations. This method includes the same measurement steps as an actuarial valuation; however, it permits simplification of certain assumptions in order for the nonspecialist to determine the employer's ARC.

Net OPEB Obligation—Measurement

The cumulative difference between the annual OPEB cost and what the employer contributes to the plan is defined as the net OPEB obligation. This obligation is modified somewhat by the amount the employer may have contributed to the plan in excess of the annual required contribution, including the OPEB liability or assets actuarially determined at the year of transition. If an employer has a net OPEB obligation, then the measure of the OPEB cost must equal (a) the ARC, (b) one year's interest on the net OPEB obligation, and (c) an adjustment to the ARC to offset the effect of actuarial obligation of past under- or over-contributions. The statement generally provides for prospective implementation so that the employer's net OPEB obligation as of the beginning of the initial year is set to zero.

Financial Statement Recognition and Disclosure

Once the cost of an employer's OPEB plan has been determined, the expense associated with the ARC, as well as net OPEB obligations, including under- or over-contributions to the retirement plan's liability or asset, must be recorded in the financial statements.

OPEB expense will be recognized in an amount equal to the annual OPEB cost in the governmentwide statements and in the financial statements of proprietary and fiduciary funds.

Governmental funds with an OPEB liability should recognize expenditures related to OPEB on the governmental fund financial statements on the modified accrual basis.

Net OPEB obligations, including under- and over-contributions, should be recognized as liabilities (or assets) on governmentwide statements and on the financial statements of proprietary and fiduciary funds.

In addition to the cost information shown on the financial statements, employers are required to disclose descriptive information about each defined benefit OPEB plan in which they participate, including the funding policy followed. Sole and agent employers must provide descriptive language regarding their actuarial valuation process and assumptions for determining the actuarial amount for ARC, their annual funding policy, and the related impact on the net OPEB obligation. Schedules and notes must be provided as required supplementary information (RSI) that denotes trends in funding progress for the most recent and two previous valuations.

EFFECTIVE DATE AND TRANSITION

The requirements of this Statement are effective in three phases as defined for implementation of Statement No. 34. Phase I governments are those whose total annual revenues were $100 million dollars or more. Phase II governments were those with total revenues of $10 million to $100 million dollars. Phase III governments were those with total revenues of less than $10 million dollars. All of these dollar amounts refer to total revenues received in the first fiscal year ending after June 15, 1999.

For purposes of Statement No. 45, the implementation dates by which governments should apply the requirements in financial statements by phase are:

Phase	Fiscal years beginning after
Phase I	December 15, 2006
Phase II	December 15, 2007
Phase III	December 15, 2008

Earlier implementation is encouraged. This statement also applies to all component units that must implement the same year as their primary government.

ACQUIRING AN ACTUARIAL FIRM

Statement 45 requires, in most instances, that a municipality contract with an actuarial firm to perform the calculations required to determine OPEB liability. Actuarial firms provide financial advisory services that are defined in T.C.A. § 12-4-106(b) as professional services and are, therefore, not subject to the competitive bidding process. Contracts for professional services are to be awarded to firms on the basis of recognized competency and integrity rather than competitive bids. The code does, however, stipulate that the services are to be performed by the financial advisor pursuant to a written contract specifying the services to be rendered and the cost of service.

Although competitive bidding is prohibited when awarding contracts with firms offering professional services, municipalities often use the request for proposal (RFP) process to define the scope of services required from the provider and to obtain information needed to evaluate a firm’s competency and experience.

The following items are recommended for inclusion in a municipality’s request for proposal:

- Background information related to the government
  - Purpose of the valuation;
  - Date of incorporation;
  - Number of active benefit plan participants; and
  - Number of retiree benefit participants.
- Valuation of the current retiree benefit plan.
- Options to the plan if being considered
  - Enhancement of benefits;
  - Reduction of benefits; or
  - Two-tiered benefit plans.
- Submittal requirements
  - Summary of the firm’s experience in similar projects;
  - Client reference and contact information;
  - Discussion of methodology to be employed in the valuation;
  - Identification of and biography information for staff members assigned to the project; and
  - RFP submittal time and date.

- Selection criteria
  - Firm's experience and client references;
  - Methodology; and
  - Fee proposal.

By using the request for proposal process, a municipality is better prepared to communicate its needs regarding the actuarial valuation, and the firm submitting a proposal is better informed of the project parameters. A sample "fill-in-the-blank" RFP requesting the services for an actuarial valuation is attached.

This overview is sourced from Statement No. 45 of the Government Accounting Standards Board. For more complete information regarding the implementation of this standard, please refer to the full document entitled *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

REQUEST FOR PROPOSALS

ACTUARIAL VALUATION OF POSTEMPLOYMENT BENEFITS OTHER THAN PENSIONS (OPEB)

The City of ________________ (*insert city name*) is seeking proposals from qualified firms to complete an actuarial valuation of the City's retiree ________________ (*insert city's life, health, vision, etc. benefit plan as appropriate*) insurance plans. This valuation shall be performed in compliance with the actuarial standards/ methods included in the Government Accounting Standards Board Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (OPEB).

Background

The City of ________________ (*insert city name*) currently provides ________________ (*life, health, vision, etc.*) insurance benefits to qualifying retirees through fully insured plans. A summary description of the retiree insurance benefits is included at the end of this RFP.

The City of ________________ (*insert city name*) was incorporated in ________________ . For the fiscal year beginning July 1, _________ , there are _________ budgeted full-time employees and _________ retired employees and spouses. Currently, retiree ________________ (*life, health, vision, etc.*) insurance benefits are funded on a pay-as-you-go basis.

Purpose of Valuation

Given the number of retirees who already receive ________________ (*life, health, vision, etc.*) insurance benefits and the number of current employees who will reach retirement age and qualify for retiree insurance benefits over time, the City wishes to proceed with the actuarial valuation and accurately assess its liability for these postemployment benefits in compliance with GASB Statement 45.

The GASB requirement will go into effect for the City of ________________ (*insert city name*) in FY 20_________ (July 1, 20______ – June 30, 20______). The results of this valuation will be used to assist the City in preparing for compliance with the GASB standard as it goes into effect and guide the City in making policy decisions regarding possible modifications to its existing retiree ________________ (*life, health, vision, etc.*) insurance benefit programs.

Scope of Work

The proposed valuation shall consist of the following:

Phase 1 will consist of the actuarial valuation to determine the City's liability for the existing retiree _________(*life, health, vision, etc.*) insurance programs. This valuation shall be completed in a manner so as to comply with all of the actuarial valuation requirements of GASB Standard No. 45.

This phase will include a minimum of three meetings, including a kick-off meeting with City staff to discuss the proposed valuation, clarify issues regarding benefit plans, etc.; a meeting with staff at the conclusion of the valuation to review results; and a briefing for the city's governing body to review the results.

(OPTIONAL)

Phase 2 would consist of an analysis of possible plan modifications or alternatives for City consideration. Initiation of Phase 2 would be at the City's option based upon the results of Phase 1. If the City chooses to initiate Phase 2, the exact scope of work and fee would be negotiated at that time.

RFP Submittal Requirements

Submittals in response to this RFP shall include the following:

1. Summary of the firm's experience in similar projects, including client reference contact information;
2. Discussion of the proposed methodology to be employed in the valuation;
3. Identification of and biography information for staff member(s) to be assigned to the valuation;
4. Proposed valuation schedule;
5. List of required data elements and other information to be provided by the City; and
6. Valuation fee proposal (Phase 1 only) and proposed payment terms.

Selection Criteria

City staff will review all submitted proposals and may choose to invite one or more firms for an interview to further discuss their proposal. Selection of a recommended firm will be based on three factors:

1. The firm's experience in similar projects;
2. The proposed methodology and valuation schedule; and
3. The fee proposal.

The selection criteria are intended to allow the City to select the firm that submits the best overall proposal, not just the lowest cost proposal.

RFP Submittal Deadline

Proposals in response to this RFP should be sent to:

(*Name*)
(*Title*)
(*Mailing Address*)
(*City, State, Zip Code*)

To be considered, proposals must be received by ________ (*time*) on ________ (*day, month, year*). No faxed proposals will be accepted. All proposals should have the words "RFP Response" on the front of the envelope. Proposals will not be opened publicly.

Any questions regarding this RFP should be directed to:

(*Name*)
(*Title*)
(*Mailing Address*)
(*City, State, Zip Code*)
(*Telephone number and e-mail address*)

(Attach appendices from appropriate sections of the city personnel policy that describe the health plan benefits for current employees and retirees.)

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