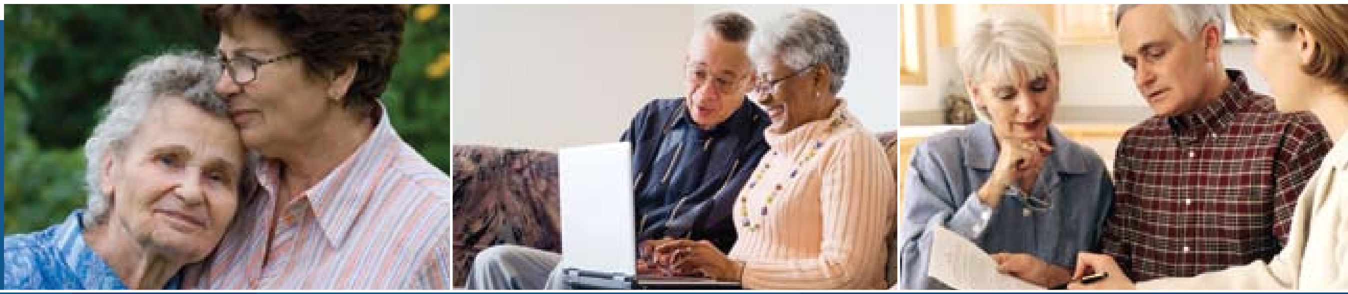
Center for State & Local Government Excellence

Issue Brief

A Guide to Implementing GASB 45



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As larger local governments have begun to implement GASB 45, there is much to learn from their experience. In North Carolina, for example, local governments with revenues over $100 million are following practices that may be instructive to smaller jurisdictions and to local governments in other states.

North Carolina local governments have relied on expertise from national and state organizations to guide their actions. They have used the Government Finance Officers Association (GFOA) model RFP that details a scope of work that requires the calculation of the actuarial present value of projected benefits, the actuarial value of assets, and the annual gain/loss in unfunded actuarial liabilities.

To help local governments tap a well-known actuarial firm's services, the North Carolina League of Municipalities and the North Carolina Association of County Commissioners contracted with an actuary that local governments could retain, should they so choose. Of the 25 localities that responded to the authors' survey, 88% had contracted with the actuary the state organizations had selected.

Some early trends can be reported: (1) NC survey respondents report they have a multi-year contract with the actuary; (2) the actuaries for all respondents applied a realistic discount rate; and (3) when they are unsure if their bond rating might be affected, local governments take the initiative to seek advice from bond-rating firms.

The Center for State and Local Government Excellence examines issues that are important to attract and retain the talent needed for public service. With heightened emphasis on the economic security of current and future retirees and increasing fiscal pressures, government leaders need the best information available. The Center helps by providing them with authoritative data and analyses of promising practices.

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Elizabeth K Kellar

Elizabeth K. Kellar
Executive Director
Center for State and Local Government Excellence

A Guide to Implementing GASB 45

Charles K. Coe*

In 2004 the Governmental Accounting Standards Board (GASB) issued Statement No. 45 (GASB 45), which requires state and local governments to report the current value of other post-employment benefits (OPEB) such as medical, dental, vision, hearing, life, disability, and long-term care insurance. Before GASB 45 most state and local governments recognized these items as expenses only when retirees received benefits, not when benefits were granted and earned. In this pay-as-you-go (PAYGO) method the government does not set aside funds to meet the growing future OPEB costs.

Before GASB 45 many governments did not know the value of the OPEB commitments they had made to their employees. GASB requires governments to make an actuarial valuation to determine the actuarially accrued liability (AAL). If a government does not fund its OPEB benefits liability, the financial obligation must be reported on balance sheets. The amount of the unfunded liability must be disclosed in the notes to the financial statement but is not reported as a financial liability.

GASB 45 is being implemented in three stages. Phase I governments (annual revenues greater than $100 million) implemented the standard by the end of FY 2008; Phase II governments ($10-$100 million) will implement by the end of FY 2009; and Phase III (less than $10 million), by the end of FY 2010. This report discusses steps local governments should take or consider taking to implement GASB 45.

To evaluate how Phase I local governments in North Carolina have implemented GASB 45, an electronic survey was sent to them in August 2008. A survey mailing, including a cover section explaining the general purpose of the survey, was sent to these Phase I cities and counties. A follow-up electronic survey was sent to non–respondents. Completed surveys were received from 25 of 30 local governments (83%).

*Charles K. Coe is a professor of public administration in the School of Public and International Affairs at North Carolina State University.

Actuarial Valuation

Table 1 is a checklist of actuarial-valuation practices. The actuarial valuation should occur sufficiently ahead of the GASB implementation date to give governing-board members time to consider their policy options. Twenty-one respondents had their actuarial valuation conducted at least one year before the deadline. Three local governments conducted the valuation in the implementation year (2008), two of which did not completely consider their implementation options.

Table 1. *Actuarial-Valuation Checklist*

Steps	✔
Prepare the actuarial valuation early enough to make GASB 45 policy decisions	
Prepare a Request for Proposals that specifies: • The local unit will collect demographic and other data. • The actuary will complete the valuation in a timely fashion (e.g., 10–12 weeks). • A description of health plan including benefits, type of plan, assets, health coverage levels. • The desired scope of work: the actuary will calculate the actuarial present value of total projected benefits, the actuarial accrued liability, the actuarial value of assets, the annual gain/loss in the unfunded actuarial liability and the implicit rate subsidy. • The actuary will be paid extra for costing out alternative scenarios. • The actuary will provide information about the firm. • A project completion timeline. • The contract is over several years.	
Based on the proposals, select an actuary with GASB 45 experience.	
The actuary applies a realistic discount rate.	

Prepare an RFP

As with other professional services, local governments should prepare a request for proposals (RFP), not a request for bids, to select the actuary. A bid is normally awarded to the lowest-cost bidder, whereas a proposal weighs both experience and price.[1] An OPEB actuarial valuation is complex, requiring an actuary with relevant experience. All 25 respondents selected a highly experienced actuary. Staff of the North Carolina League of Municipalities and the North Carolina Association of County Commissioners contracted with an actuary whose services cities and counties in the state could retain if they wished. Twenty-two governments contracted with the actuary.

RFP's Provisions

Governments should carefully design the RFP. Table 1 indicates provisions to include in an RFP.

First, to reduce the cost of the valuation, the government, not the actuary, should collect background data needed to make the valuation. All 25 respondents collected such data.

Second, the valuation should be completed in a timely fashion. The contract should specify the period within which the valuation will be completed. For instance, one contract specified a 10- to 12-week completion period.

Third, the RFP should give a description of the current health plan (e.g., assets, benefits, coverage levels) and itemize a detailed scope of work of work (SOW). The Government Finance Officers Association (GFOA) has prepared a model RFP that details a SOW requiring the calculation of the actuarial present value of projected benefits, the actuarial value of assets, and the annual gain/loss in unfunded actuarial liabilities (See http://www.gfoa.org/downloads/OPEBChecklistfinal.pdf). GASB and GFOA recommend that the actuary calculate the *implicit price subsidy* (GASB 2004, GFOA 2007). Governments often provide benefits to employees and retirees under the same plan. Since retirees use more benefits than current employees, current employees "implicitly" subsidize their costs.

Fourth, the RFP should allow the local unit to pay additional compensation to the actuary to cost out alternative funding scenarios such as changing benefits. One contract, for instance, includes a provision permitting the local unit to negotiate a fee for extra service at an hourly rate ranging from $100 to $360, depending on the service.[2]

Finally, the RFP should require background information about firms making proposals, the completion timeline, the pricing method and other terms of the agreement. GASB requires a valuation at least every two years if a government has 200 or more employees and at least every three years if less than 200 employees. The contract should be for more than a one-year period. In the first valuation, an actuary incurs higher costs to learn about government's particulars, which can be amortized future valuations. All contracts provided for multi-year contracting.

Apply Realistic Discount Rate

In making a projection, the actuary should apply a realistic discount rate. The discount rate, the interest rate earned on investments, should be consistent with return on investments expected to finance the payment of benefits (GASB 2004). The higher the discount rate, the smaller will be the calculated liability; however, an unrealistically high discount rate simply masks the true liability. The actuaries for all 25 local governments applied a realistic discount rate.[3]

GASB 45 Policy Setting

The actuarial evaluation will reveal the amount of the annually required contribution (ARC), which is the amount needed to fund OPEB liabilities over 30 years. Nationally, the amount of OPEB liability for a small to midsize municipal government is estimated at a manageable $39–210 per capita (Marlowe 2007: 106). To decide whether to prefund all or a part of the liability, the governing board may need added information. Table 2 indicates the steps needed to gather such information and the policy decisions that a governing board can face.

Gather Preliminary Information

Human resources (HR) and finance departments should cooperate in preparing the implementation plan. Cooperation enables the finance team to better understand the benefits package and the HR team to better understand fiscal and budgetary implications (Sanford 2007: 13). If a benefits change is considered, a local unit may wish to engage the services of a specialized health care consultant as did seven of 25 respondents (28%).

The credit quality of local governments with low to average OPEB liability and higher than average fiscal capacity will likely not be affected (Marlowe 2007: 108).[4] However, the credit quality of local governments with high OPEB liability and less fiscal capacity will likely decline (Marlowe 2007: 108). A local unit may therefore want to know whether its present and future OPEB liability will adversely affect its bond rating. Fifteen of 25 respondents (60%) discussed their GASB 45 situation with bond-rating firms in conjunction with a bond-issue presentation.

To set an OPEB policy, the governing board may wish to sound out the sentiments of its employees. Governments may meet with union leaders and/or survey employees. In North Carolina none of the respondents surveyed its employees. This may be because no governments reduced the benefits of current employees or because North Carolina is a right-to-work state, which discourages unionism.

Governing Board's Policy Decisions

After gathering background information the governing board should make some or all of the policy decisions shown in Table 2. To reduce the ARC the government may reduce the benefits of current employees, future employees, and/or retirees. Courts in North Carolina have not addressed whether a local unit can eliminate or reduce retiree benefits (Juffras 2004: 16). However, the Fourth Circuit Court of Appeals (whose jurisdiction includes North Carolina) held in *Baltimore Teachers Union v. Mayor and City Council of Baltimore* that salaries of current employees could be reduced if the cut was temporary and basic services were threatened. None of the respondents reduced the benefits of current employees or retirees, but six of 24 governments (25%) did increase the time needed to vest.

Each governing board must decide whether to fund any or all of the actuarially required contribution (ARC), which is the normal cost for a year plus the amortized portion of total unfunded actuarial liabilities. Eighteen governments stayed with PAYGO financing (72%); four governments decided to totally fund the ARC (16%); and three governments had made no decision at the time of the survey (12%). Two reasons may explain why so many stayed with PAYGO: (1) the possibility of national health insurance might make OPEB funding unnecessary; and (2) the amount of the ARC may be insignificant.[5]

GASB recommends, but does not require, that a government that prefunds the ARC totally or partially place the funds in an irrevocable trust. Since a trust is long-term, funds can be invested in equities and other high-yield instruments that states normally prohibit. The downside of creating a trust is that governments cannot withdraw funds after being irrevocably placed in trust. Five of 22 governments (23%) established such a vehicle; three governments did not answer the question. Governments that create such a trust are advised to hire an outside counsel because of the trust's highly specialized nature. The government should then designate a trustee with fiduciary responsibility to act as custodian over the assets.

Table 2. *GASB 45 Policy-Setting Checklist*

Steps	✔
Gather preliminary information • HR and Finance departments cooperate to develop policy options. • Use healthcare consultant for advice on amending OPEB. • Analyze effect of OPEB on the budget. • Meet with bond-rating agencies. • Survey employees' priorities.	
Governing board makes policy decisions • Set the ARC funding level. • Reduce benefits: Current employees Future employees Retirees • Use outside counsel to write an irrevocable trust agreement. • Select a trustee as custodian over trust fund assets. • Adopts a GASB 45 policy or include GASB 45 provisions in an overall health strategic plan. • Communicate changes to employees.	

GASB 45 Implementation

Table 3 lists possible implementation steps. Annual OPEB costs can be budgeted exclusively in the general fund or be allocated across *all* funds. The latter method is advisable because all employees, regardless of their budgetary location, will receive retiree benefits and therefore should pay for them. Costs can be allocated among funds based on the relative number of employees or amount of payroll each has. Ten of 20 respondents (50%) allocated across funds; five respondents did not answer the question.

Governments that prefund all or a part of the ARC will have funds to invest. Most governments have an investment policy guiding shorter-term investments. If a government creates an irrevocable trust, however, funds can be invested in higher-yielding but riskier investments like equities, in which case the governing board should adopt an investment policy specifying the

Table 3. *GASB 45 Implementation Checklist*

Possible Steps	✔
Allocate annual costs among funds	
Adopt a cost-allocation plan	
Adopt a GASB 45 investment policy	
Invest in OPEB trust fund	
Issue taxable long-term debt	

desired investment quality of investment instruments and the percentage of assets that can be invested in fixed-income securities versus equities. The comptroller of the State of Tennessee has prepared a sample OPEB Trust Investment Policy.

However, none of the five respondents that pre-funded the ARC has adopted a policy. In North Carolina, local governments can invest in a state-run OPEB trust fund, whose portfolio includes higher-yielding instruments like equities or they can create a fund similar to the state-run OPEB trust fund. Charlotte created such a fund; the four other governments are using state OPEB trust fund but may create their own fund in the future. Whatever the fund arrangement, governments should regularly review investment performance to ascertain whether their investment goals are being met.

To prefund OPEB liabilities, some states permit governments to issue long-term general-obligation debt in bonds or certificates of participation. The investment return on the debt is greater than the interest paid, allowing the local unit to use the difference to pay all or part of the ARC. However, North Carolina does not permit the issuance of debt for OPEB liabilities.

Finally, a governing board may either adopt a stand-alone GASB 45 policy or include GASB 45 provisions as a part of an overall health strategic plan. Governments that adopt a policy should communicate its provisions to employees. None of the 25 respondents formally adopted a GASB 45 policy or health strategic plan.

Conclusion

The law in states outside North Carolina may bind local governments differently than does North Carolina law. As earlier stated, some states permit the issuance of long-term debt to pay for OPEB liabilities. Non-right-to-work states may have to work more closely with unions and may be more constrained by labor agreements. States like New Mexico and Florida mandate that local governments contribute to a state-managed retiree health fund (Sanford 2007: 14). Finally, states may not offer local governments the opportunity to invest in statewide OPEB trust funds as North Carolina does.

Nevertheless, certain practices hold true regardless of state law. Local governments should select an actuary highly experienced in making GASB 45 valuations. A request for proposals, not bids, should be issued that clearly defines the desired scope of work. The actuary should not inflate the discount rate. Finally, the governing board should systematically gather information to inform its decision whether to prefund the OPEB liability.

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Endnotes

1 The government can reject the lowest bid if the bidder has been neglectful in furnishing a good or service in its past dealings with the government.

2 Five governments asked for alternative scenarios. Two governments asked for two scenarios; one for three scenarios; and two for four scenarios.

3 In this case the actuary applied a discount rate of 4% for the governments using PAYGO financing and a rate of 7% for the governments that fully funded the AAL, which is the rate of the NCLGERS. Winston-Salem and Charlotte did not use the same actuary but fully funded the AAL, used discount rates of 8% and 7.5%, respectively. The General Accountability Office found that 70% of state and local pension trust funds assumed a rate of 8.0%–8.5%, and 30 percent assumed a rate of 7% (2008).

4 Fiscal capability was defined as (1) per capita general fund tax effort and (2) the general fund current ratio (Marlowe 2007: 108).

5 The amount of the ARC will be known in early 2009 when local governments submit their annual financial report to the state Department of Treasurer, Local Government Commission.

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777 N. Capitol Street NE | Suite 500 | Washington DC 20002-4201 | 202 682 6100 | info@slge.org

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