

# GASB 45 and Other Postemployment Benefits: Understanding the Governmental Landscape

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In June of 2004, the Government Accounting Standards Board (GASB) issued Statement 45, which deals with the accounting and financial reporting of post-employment benefits other than pensions (OPEB). GASB was motivated to act because OPEB obligations, of which retiree healthcare expense is the most common benefit, are a significant financial commitment for many state and local governments. These benefits represent an estimated \$1.5 trillion in unfunded liabilities nationwide.<sup>1</sup>

While GASB 45 will not have detrimental effect on all governments, it will have a significant impact on the majority of employers that use the current pay-as-you-go accounting method.

The pay-as-you-go accounting approach allows employers to report OPEB expenses after employees retire. The problem is that pay-as-you-go does not accurately reflect the total cost of future benefits promised to employees. Currently, 26 states account for these benefits on a pay-as-you-go basis.<sup>2</sup>

In general, GASB 45 will require governments to more accurately report OPEB expenses by switching to an accrual method of accounting. Employers will be required to report the estimated cost of benefits for each year the employee provides services to the employer. The total amount of benefits for all employees will be calculated as the annual OPEB cost. For many governments, this

will be a significant increase (ranging from 3-10 times) over their current pay-as-you-go costs.

## Compliance Deadlines

The effective date of compliance with the new requirement is determined by the government's size. There are three phases for implementation of GASB 45:

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- Phase I: Governments with revenues greater than \$100 million must comply for reporting periods beginning after December 15, 2006.
- Phase II: Governments with revenues between \$10-100 million must comply for reporting periods beginning after December 15, 2007.
- Phase III: Governments with revenues less than \$10 million must comply for reporting period beginning after December 15, 2008.

## The Effects of Underfunding

Employers will be required to determine their current liabilities through an actuarial study. The total amount of promised benefits will be represented as an accrued liability. To the extent that the government has not set aside assets to cover these benefits, they will receive a statement of their unfunded actuarial accrued liabilities (UAAL). These liabilities will ultimately end up on the government's balance sheet as a net OPEB obligation (NOO).

<sup>1</sup> "You Dropped a Bomb on Me, GASB," David Zion, CFA, CPA, Amit Varshney, FRM, Credit Suisse, March 22, 2007.

<sup>2</sup> IBID

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Governments failing to take steps to address their liabilities face possible downgrades to their credit rating, thereby increasing future borrowing costs. A second consequence is the potential political hailstorm that may arise as the public begins to understand the extent of these liabilities and the lack of preparation in funding.

## Establishing Trusts

In order to properly address OPEB liabilities, GASB requires the establishment of a dedicated OPEB trust into which assets may be placed to fund the future liabilities. Assets placed in an irrevocable trust may be counted by an actuary to offset current liabilities, which can reduce current annual OPEB expenses.

Another benefit of establishing a trust is that GASB 45 allows the use of a more favorable interest (discount) rate assumption to calculate OPEB liabilities, thereby lowering the government's total liability. Once a trust has been established, the liability can be funded in a number of ways.

## Funding Options

There are three primary funding methods available to address these liabilities:

- Pay-as-you-go
- Annual required contributions to pre-fund the liability
- Bond issuance to pre-fund the liability

Continuing the pay-as-you-go method will probably provide the least relief in terms of OPEB obligations as it makes no attempt to address the growing liabilities.

Making annual required contributions will ultimately reduce the liability by amortizing the UAAL over a period of time (not

to exceed 30 years) and taking advantage of investment returns on assets placed in trust. Employers may also make contributions that exceed their pay-as-you-go amount but do not completely meet their annual required contribution amounts.

Pre-funding through bond issuance, either as a general obligation of the government or by issuing some form of trust notes, opens up numerous possibilities for funding OPEB obligations. Issuing bonds will lower the government's out-of-pocket costs to a greater extent than making annual required contributions and lowers the present value cost of providing the benefits.

## Obstacles and Pitfalls

Deciding how to fund OPEB liabilities depends upon many factors and varies from state to state. The following list represents some of the factors that must be considered when funding OPEB obligations; however, given the complexity of factors and state regulations involved, this list is not intended to be all-inclusive:

- Current cash flows
- Reserve and general fund balances
- State and local investment and bond restrictions
- Fiduciary liability
- Appropriateness of investments
- Negotiation tactics with employees
- Impact on credit rating
- Legislative changes

Many governments are currently working on ways to address their liabilities, lobbying for legislative changes and establishing and funding trusts. Governments continue to address these issues and many have acknowledged the need for investment consulting services.

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## The Role of Citi Institutional Consulting

Government entities face a number of complex OPEB issues such as complying with GASB guidelines, meeting fiduciary requirements, determining prudent return targets and establishing the appropriate funding levels needed to meet future benefit obligations.

At Citi Institutional Consulting our mission is clear: to set the industry standard in investment consulting services by helping sophisticated investors develop prudent strategies.

Based on our in-depth research capabilities, Citi Institutional Consulting may

recommend customized asset allocation strategies that can help achieve the asset growth needed to fund future OPEB obligations.

While we do not provide tax and legal advice, we offer numerous other strategies to help you manage your liabilities and obligations. These include detailed asset/liability studies, investment policy statements and customized investment strategies featuring both traditional and alternative asset classes.

To learn more about the objective investment advice provided by Citi Institutional Consulting, contact your Institutional Consulting Director.

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## Glossary

**Government Accounting Standards Board (GASB):** The mission of the Governmental Accounting Standards Board is to establish and improve standards of state and local governmental accounting and financial reporting. Their efforts are designed to result in useful information for users of financial reports and guide and educate the public, including issuers, auditors, and users of those financial reports. GASB is not a federal agency nor does it possess the power to enforce its recommendations. For more information, visit them at <http://www.gasb.org>

**Net OPEB obligation (NOO):** This term refers to the cumulative difference between the plan's annual required post-employment benefit contribution and the actual post-retirement benefit contributions.

**Post-employment benefits other than pensions (OPEB):** As a component of their employee hiring and retention packages, many state and local governmental employers often provide their employees with other post-employment benefits (OPEB) as part of total compensation. According to GASB, OPEB typically includes post-employment healthcare and other forms of benefits, such as life, disability and long-term care insurance, prescription drugs or other benefits when provided separately from a pension plan.

**Unfunded actuarial accrued liabilities (UAAL):** The Society of Actuaries defines an actuarial accrued liability (AAL) as the portion of the actuarial present value of an organization's total projected benefits allocated to years of employment prior to the measurement date; UAAL is the unfunded portion of this calculation.

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