State, Local Governments Face New Accounting Rules Related to Other Post-Employment Benefits

In June 2004 the Governmental Accounting Standards Board (GASB) established new accounting rules for state and local governments and related agencies. With unfunded liabilities of as much as $1.5 trillion*, the soon to be implemented accounting and reporting rules, promulgated by GASB under Statements 43 and 45, will have far-reaching implications for governmental units that sponsor Other Post-Employment Benefits (OPEB). OPEB are primarily healthcare benefits for retirees but also include post-employment life insurance, disability and long-term care benefits.

It will not be surprising to see the budget line for non-pension retiree benefits increase by multiples of five to 10 times. The additional expense reflects the accrual of OPEB costs over the working years of the employees who may eventually enjoy the underlying benefits. As the implications of the GASB Statements 43 and 45 unfold, it is possible that without substantial pre-funding, the borrowing power of the plan sponsor may be adversely affected. Thus, there may be cash demands on the governmental body to pre-fund OPEB in an irrevocable trust, like a pension plan.

The implications of the new GASB requirements may be significant. Public sector plan sponsors are therefore advised to meet with their accountants, legal counsel, benefit consultants, investment counselors and actuaries as soon as possible to determine the possible impacts on them.

Below we provide some information and insight in the following areas:

- Background and effective dates
- Initial evaluation steps
- Funding
- Strategy

**Background and Effective Dates**

Continuation of OPEB in retirement is quite common in the public sector. To date, the way to account for these benefits has generally been "pay-as-you-go," with the accounting expense essentially the same as the cash paid to provide benefits to current retirees. For pensions and now OPEB, GASB has followed the private sector Financial...
Accounting Standards Board by requiring accrual-based accounting for post-employment benefit expenses. In general, unfunded pension obligations should be reported as a liability by the employer.

The GASB 45 effective date depends upon the "phase" into which the governmental entity’s revenues fall, as summarized in the following table:

**GASB 45 Effective Dates**

<table>
<thead>
<tr>
<th>GASB Phase</th>
<th>Annual Revenue</th>
<th>Effective Periods Beginning After</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100 million +</td>
<td>12/15/2006</td>
</tr>
<tr>
<td>2</td>
<td>$10 to $100 million</td>
<td>12/15/2007</td>
</tr>
<tr>
<td>3</td>
<td>Less than $10 million</td>
<td>12/15/2008</td>
</tr>
</tbody>
</table>

**Initial Evaluation Steps**

Plan sponsors should meet with their accountants to be sure that everyone is in sync as to the effective dates and exactly what information will be needed and when. The benefits advisors, accountants and actuaries will also want to help determine whether the plans are subject to the GASB 45 actuarial requirements. Certain plan vehicles are not subject to such requirements. However, if subject to actuarial evaluation, the plan sponsor may want to engage an actuary as soon as possible to assist in understanding the magnitude of the liabilities associated with its post-employment benefits.

**Funding**

A key GASB 45 concept is the annual required contribution or "ARC." If the ARC is not funded or is just partially funded, the plan sponsor must disclose the cumulative under funding of the ARC. Under funding the ARC results in a net post-employment benefit obligation, or "NOPEBO," which will be disclosed each year in financial statements. Credit rating agencies have indicated that a plan sponsor with a large NOPEBO might experience a reduction in its credit rating.

A significant funding-related issue is the discount rate assumption used by the actuary to determine the present value of future OPEB plan payments. GASB 45 allows the actuary to use a higher discount rate for plans that are funded at the ARC level, resulting in much lower liabilities. Accordingly, funding decisions will require extensive analysis and actuarial input.

**Strategies**

As the interested parties understand the implications, there may be pressure to modify the underlying benefits, add new cost control measures, shift costs and/or develop funding strategies. This will all take significant planning and due diligence, and thus we suggest public plan sponsors commence the evaluation process as soon as possible.
For more information regarding the GASB Statements 43 and 45, please contact your Northern Trust relationship manager. In addition, the following Web sites will provide more information: www.gasb.org and www.gfoa.org.

*Source: Credit Suisse "You Dropped a Bomb on Me, GASB"

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