

# Assistance and Guidance Report



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## Other Postemployment Benefits (OPEB)

Report #0819

September 18, 2008

### Summary

In June 2004, the Governmental Accounting Standards Board (GASB) issued Statement No. 45 on Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions. As a result, this statement became part of the body of knowledge known as generally accepted accounting principles (GAAP) and must be followed in the preparation and issuance of the City's Comprehensive Annual Financial Report for the 2007-2008 fiscal year.

Other Postemployment Benefits (OPEB) includes government healthcare, prescription drugs, and life insurance provided to employees during their retirement years. Historically, employees have been promised that in return for their services the City will pay a portion of their monthly healthcare premium when they retire. The City has made good on this promise by annually appropriating and expending current operating funds for its share of retiree healthcare premiums as they came due. This method of funding is referred to as a "pay-as-you-go" approach. As such, the City has not in the past set aside any monies to pay for future healthcare subsidies for current retirees or for employees currently working that will retire in the future.

GASB Statement No. 45 now requires recognition of OPEB costs at the time an employee provides services to the government. In other words, an accounting event has occurred and should be recognized at the time when there is an "exchange of benefits for services."

Historically, in exchange for services rendered by employees, the City has biweekly paid employees a salary and has at the same time set aside monies for its portion of the City pension to be paid employees in the future. However, the City (like many other cities nationwide) has not set aside monies for healthcare subsidies also promised employees in the future. As a result, a significant UAAL (unfunded actuarial accrued liability) now exists for current and retired employees that have rendered services in the past in exchange for future benefits.

GFOA (the Governmental Finance Officers Association) has stated that OPEB is a form of compensation and should always be considered as an integral part of an employee's total compensation package. Some have described OPEB as a form of deferred compensation.

For the year ending September 30, 2008, the City will be required to disclose the AAL (actuarial accrued liability) associated with OPEB in the notes to the City's financial statements along with a description of efforts and progress being made to fund the actuarial liability. If the City fully funds OPEB cost for the current year in an irrevocable trust, no liability will have to be recorded on the face of the financial statements. However, if the City does not establish a dedicated irrevocable trust fund and instead continues on a pay-as-you-go basis, the full amount of the ARC (Annual Required Contribution) will be reported as a liability in government-wide financial statements.

Even though not required, the City made early disclosure of the UAAL in its annual financial statement notes for the year ended September 30, 2007. Based on the actuary study at the time, on a pay-as-you-go basis the AAL would be \$103,362,000; whereas, if the City had established a dedicated irrevocable trust fund for OPEB, the liability would be \$60,520,000.

A July 8, 2008, updated study for the year beginning October 1, 2007, shows the AAL for an unfunded (pay-as-you-go) plan is now \$123,122,000 and for a funded (a dedicated irrevocable trust) plan is now \$73,688,000. The ARC for 2008 for an unfunded pay-as-you-go plan amounts to \$9,975,000, and the ARC, for a funded plan where monies are placed in an irrevocable trust, amounts to \$6,833,000.

The following summarizes issues relating to OPEB:

- The AAL (actuarial accrued liability) for OPEB has always been in existence; however, to date, the City has not been required to recognize or report the liability in externally issued financial reports.
- Postemployment healthcare benefits should be viewed and accounted for in the same manner as promised pension benefits. Employee salaries and benefits (including retiree pension and healthcare benefits) are earned and should be recognized at the time an “exchange of benefits for employee services” occurs regardless of when the government intends to pay for those services – even if payment is to be made several years into the future.
- Over the years, the City of Tallahassee, like the vast majority of other cities, has made a promise to employees that upon their retirement, the City will pay (contribute to) a portion of their healthcare costs. As a result, citizens at the time received employee services for which they did not help to fund. This unfunded actuarial accrued liability now conservatively amounts to in excess of \$70 million dollars. As a result, current and

future taxpayers will be burdened with previous cost incurred for which they will receive no service.

- As an example, if a special risk employee (police, fire, etc.) were to retire today at age 50 and select two-party healthcare coverage, over the next 35 years the cash flow for the City contribution toward the employee’s healthcare would amount to approximately \$125,000. For an employee not in a special risk category retiring at age 62 and eligible for Medicare coverage at age 65, the City contribution over a 20-year period would amount to over \$35,000. To date, the City, like most other state and local governments, has not set aside any monies to pay for this promised healthcare contribution.
- Not funding the City portion of post retirement healthcare cost is inconsistent with the matching concept of interperiod equity – that concept is that services provided during the period should be paid for by those that received and benefited from the services during the period. Under the new standard, OPEB cost not recognized in the past shall be recognized going forward in the period in which the employee provides services.

The GFOA has said that the real issue is not the accounting requirements for OPEB, but how governments intend to finance the cost of OPEB in an environment characterized by an increasing retirement age population and escalating healthcare cost.

To address this important issue, the City has an Employee Benefits Committee made up of the City Treasurer-Clerk, the Director of Management and Administration, and the Director of Human Resources. One of the responsibilities of this Committee is to review healthcare premiums for active and retired employees. Based on their review, the Committee recommends to the City Commission, through the budget process, the portion of the premium to be paid by the City.

For the 2009 fiscal year, the proposed budget addresses OPEB by fully budgeting the enterprise fund commitment to OPEB but not fully budgeting the general fund commitment. Since neither of these commitments will go into an irrevocable trust, the City will be required to record the full amount of the OPEB liability for 2009. Regardless, there appears to be a commitment by the Committee to recommend an irrevocable trust and a commitment to address OPEB in the future.

To address this important issue, the following recommendations are made:

- If the City Commission chooses to continue to contribute to retiree healthcare, the Benefits Committee should develop a plan and funding strategy for the 2010 budget cycle and at least the following five years for Commission deliberation and direction.
- Current union agreements and current policies or practices for nonunion employees should be reviewed to determine the City's legal requirement to continue to subsidize or authority to change the City OPEB contribution.
- If City contributions are expected to continue, strong consideration should be given to the merits of a separate irrevocable trust to account for amounts received and expended.
- The Committee has indicated that a plan will be finalized for the 2010 budget to address OPEB through a cost sharing mechanism between employees and the City. The Committee should give recognition that the unfunded actuarial accrued liability that currently exists represents an exchange of benefits for services that have already been provided by employees. The Committee should seek equity in its efforts to fund OPEB through employee cost sharing.
- The Benefits Committee should look at all options and recommend to the City

Commission the best short and long term course of action in light of the financial sustainability needs of the government; services promised to the community; and the desire to have a dedicated, competent, and professional workforce.

Research conducted for this report identified several options for funding and structuring a plan to address the impact of OPEB. Some of the options relate to what other state and local governments have already done to address OPEB and some options are those that deserve further consideration if it is necessary to change plan benefits. These options were discussed with and provided to the Benefits Committee for their review and consideration, and for their recommendations, as applicable, to the City Commission.

There should be recognition that the contribution the City currently makes to retiree healthcare was likely made in previous years in good faith and in recognition of valuable contributions made by employees in exchange for (or for foregone) salary increases. Any reduction in contributions by the City has the effect of reducing current and retiree salary and pensions, respectively. GFOA recommends that governments strive to avoid benefit reductions that place an undue burden on employees, or risk making the government uncompetitive as an employer.

In view of the significance of decisions to be made, the City Commission (through its Financial Viability of the Government Target Issue Committee) should give consideration to recommendations made by the Benefits Committee and the Office of the City Attorney.

### ***Scope, Objectives, and Methodology***

The purpose of this Assistance and Guidance Report is to provide information that the City Commission can use to make policy decisions to address the short and long term financial impact of GASB Statement No. 45. Accordingly, the objectives of this report will be to answer the following questions.

1. **What is GASB Statement No. 45 on Other Postemployment Benefits and what caused the GASB to issue this standard?** To address this objective, an overview of GASB 45 will be presented drawing on the Statement itself and various articles and presentations.
2. **What is the OPEB unfunded actuarial accrued liability amount for the City as calculated by city consultants and what makes up this amount?** To address this objective, consultant studies issued to date will be reviewed and summary information on the actuarial accrued liability for OPEB will be presented and explained.
3. **What is the Annual Required Contribution (ARC) and how is it calculated for purposes of GASB Statement No. 45?**
4. **What are the accounting and funding options available to the City to address the calculated OPEB UAAL?** To address this question, publications issued by the Governmental Accounting Standards Board and the Government Finance Officers Association (GFOA) will be reviewed as well as articles written by others that address pay-as-you-go, earmarking of funds set aside, establishing an irrevocable trust fund, and debt funding the liability.
5. **What is the long-term cost to the city when a promise is made to subsidize an employee's healthcare at retirement?** To address this question, information will be obtained from the City Human Resources Department that shows the amount the City currently contributes toward employee healthcare cost. Examples will be provided to show the obligation assumed for various positions.

This audit was conducted in accordance with the International Standards for the Professional Practice of Internal Auditing and Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit

objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Background

In June 2004, the Governmental Accounting Standards Board (GASB) issued Statement No. 45 that addresses *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*. The approach followed was similar to GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers*, issued in November 1994 which took effect for periods beginning after June 15, 1997. GASB Statement No. 45 is also very similar to FASB Statement No. 112 issued by the Financial Accounting Standards Board in 1992 and applicable to employers' accounting for postemployment benefits for the private sector and non-profit organizations.

The similarity between pension and OPEB accounting is that the cost of the benefit to be provided, even if that benefit will not occur until a future date, should be recognized in the period when there is an exchange of benefits for services. This promised benefit, even though paid out in the future, is part of the employee's current salary and benefits package. In other words, such benefits should be recognized as a cost that is part of an employee's compensation. These costs should be recognized in the period (the year) in which the employee worked, rather than in the period when the retiree receives the benefit. This OPEB liability has always existed but disclosure was not required until GASB issued Statement No. 45.

For governments that have in the past or plan to continue to follow a pay-as-you-go approach to pay for subsidized post retirement healthcare benefits, the approach has been described as "the elephant in the family living room that everyone is pretending isn't there" because it avoids recognition that an economic event took place when there was an exchange of services for benefits. Going forward, GASB Statement No. 45 will require recognition of this event in the government's annual financial report.

According to GFOA (the Government Finance Officers Association), the main thrust of GASB Statement No. 45 is to require for the first time that public-sector employers recognize the cost of OPEB over the service life of their employees rather than on a pay-as-you-go basis. GASB Statement No. 45 encourages governments to be fiscally responsible and to recognize that promises made without funding have the effect of requiring future generations to pay for a benefit for which they received no service.

Governments that were phase 1 governments for the purpose of implementation of GASB Statement No. 45 - those with annual revenues of \$100 million or more - are required to implement this Statement in financial statements for periods beginning after December 15, 2006. For the City of Tallahassee, this means for the period beginning October 1, 2007, and ending September 30, 2008.

Section 112.0801, Florida Statutes, requires that the City provide healthcare coverage to retirees at a total premium cost that is no greater than the premium cost to active employees. This statute does not require any government to contribute toward a retiree's healthcare premium. Notwithstanding, the City has historically subsidized a portion of the total premium for healthcare coverage for each retired employee. Our research has shown that some governments subsidize retiree OPEB in amounts that range from no contribution to a 100 percent contribution.

In May 2006, *USA Today* reported that nationwide most state and local governments have set aside almost nothing to pay for retiree medical benefits. A study by the Pugh Charitable Trust revealed that as of fiscal year 2006, state pension funds had funded about 85 percent of their long-term pensions cost. The same study revealed that states had set aside only 3 percent for promised healthcare and OPEB liabilities.

The unfunded actuarial accrued liability for the cost of healthcare benefits promised state and local government workers is estimated to top \$1 trillion dollars. For example, the OPEB AAL amounts to \$50 billion for the City of New York,

\$5 billion for the Los Angeles Unified School District, and as much as \$70 billion for the State of California. By comparison, neither the State of Florida nor Leon County directly contributes toward retiree healthcare premiums. When a similar accounting rule was implemented for the private sector in 1993, there was a significant reduction in benefits promised.

The publication *City and State* reported that for some governments, this means reconsidering collective bargaining agreements and retiree benefits. The most common response about OPEB has been that the first thing to do is to measure it, and then decide the right thing to do. This could involve freezing or reducing City contributions for retiree healthcare, increasing the number of years needed to vest with the government, or identifying current or additional revenue sources to adequately fund the measured amount. The belief as reinforced by Standard & Poors is that "If the problem is ignored, that will be a negative factor when we determine credit ratings."

There is also the view by employees that have already retired or are about to retire that they have a continuing commitment from their employer to receive healthcare subsidies in exchange for services previously rendered. Moreover, the requirement of GASB Statement No. 45 applies even if benefits are contingent. As noted by GFOA, because accounting emphasizes economic substance over legal form, employers may have OPEB to report even in the absence of a written plan and even where benefits are legally limited to annual appropriations by the governing body. GFOA goes further to say that simply put, OPEB exist whenever there is a mutual understanding between employers and employees that such benefits will be provided, period.

The Government Finance Officers Association (GFOA) has said that GASB Statement No. 45 "has focused attention now, as never before, on the ultimate cost of benefits to state and local government employers. Further, GASB did not create the issue of OPEB; it spotlighted a major ongoing issue that has challenged public sector financials for some time." Lastly, GFOA advises

governments to resist proposals to use debt to finance OPEB.

### ***Issues and Recommendations***

#### ***What is GASB Statement No. 45 on Other Postemployment Benefits and what caused the GASB to issue this standard?***

According to Statement No. 45 of the Governmental Accounting Standards Board, in its publication *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, OPEB (other postemployment benefits) includes postemployment healthcare, as well as other forms of postemployment benefits such as life insurance when provided separately from a pension plan. In the City of Tallahassee, postemployment benefits to date relate only to health insurance and prescription drug coverage.

According to GASB, the substance of OPEB is as follows:

- Postemployment benefits are part of the compensation for services rendered by employees; they are part of an exchange transaction between the employee and the employer.
- Benefits promised are earned and obligations accrue or accumulate during employment, even though the benefits are not received until after employment.
- The accrual basis cost for a period is part of the total cost of government services for that period, whether or not the employer chooses to fund it concurrently.
- OPEB cost should be recognized systematically over the periods approximating the employee's years of service, and OPEB benefits earned but not funded in prior periods should be amortized over a period not exceeding 30 years.

**(Please see Exhibits 1 and 2 attached to this report for a further explanation of OPEB.)**

Prior to GASB Statement No. 45, there was no requirement to recognize OPEB for promises made to subsidize future healthcare premiums. In addition, there was no requirement to either estimate the cost of those benefits promised, or to

set aside funding to pay for benefits promised in future periods. Accordingly, the City, like many other governments nationwide, followed a pay-as-you-go approach, meaning the City subsidized healthcare premiums when submitted for payment even though the service giving rise to the payment was performed in prior periods.

GASB issued Statement No. 45 to ensure that government financial statements account for the current exchange of services rendered for benefits received even though those benefits may not be paid until an employee's retirement years.

One comment often made is that GASB does not require employers to advance fund OPEB. Accordingly, some have taken this to mean that it is acceptable to not advance fund OPEB. To address this issue, and possible (mis) understanding, the reason GASB made this statement is that GASB has no authority over the budgeting and financing practices of state and local government. Any decision to advance fund OPEB or to continue on a pay-as-you-go basis is one to be made by the government's elected officials.

A similar analogy can be made about employee salaries – GASB cannot require governments to fund salaries; however, GASB can require the government to report the expense and if not paid the related liability. What GASB is responsible for is to assure that issued financial statements properly reflect the government's funding decisions and accordingly its liabilities. Those decisions apply to the period in which the decision or promise is made to provide future benefits, not to the period when the benefit will be received, which may be many years in the future.

#### ***What is the OPEB unfunded actuarial accrued liability amount for the City as calculated by City consultants and what makes up this amount?***

On March 14, 2008, the City of Tallahassee issued its Comprehensive Annual Financial Report (CAFR) for the year ended September 30, 2007. In the notes to the financial statements, the City disclosed information relating to Other Postemployment Benefits. In those notes, the

City disclosed that we are currently on a pay-as-you-go basis meaning that the cost of healthcare subsidies for retirees is recognized during the period paid.

In hindsight, the pay-as-you-go method of funding healthcare benefits was not the most fiscally responsible way to address this issue. However, the City of Tallahassee was part of the vast majority of local governments that also used the pay-as-you-go funding approach. Accordingly, the AAL has always been there and GASB has now addressed the issue to require state and local governments to recognize these past periods when cost were incurred but not recognized.

In accordance with GASB Statement No. 45, the City will be required to implement OPEB standards for the year ending September 30, 2008. Given that services giving rise to this benefit were provided by employees in the periods when they were working, the City will be required in the coming year to recognize in its externally issued annual financial reports:

1. Those promised but unfunded benefits (healthcare costs) that have occurred in prior years;
2. Any healthcare costs for the 2007-2008 fiscal year that are in excess of funding restricted for that purpose; and
3. An implicit amount that recognizes the difference in healthcare cost for retired employees as compared to active employees.

In February 2007, the City received a study conducted by Buck Consultants on the actuarial valuation of the City’s retiree health benefits. In that report, the consultants estimated the City obligation for retiree healthcare benefits as of October 1, 2005, as follows:

1. If the plan remains unfunded (pay-as-you-go basis) the actuarial accrued liability to be recognized amounts to \$103,362,000.
2. If the plan were funded in an irrevocable trust, the actuarial accrued liability to be recognized amounts to \$60,520,000.

Most recently, on July 8, 2008, the City received an updated report summarizing the actuarial

valuation for retiree benefits for the fiscal year beginning October 1, 2007. This updated report will be used to disclose information about OPEB in the City financial report for the year ended September 30, 2008. The consultant’s updated report now estimates the City obligation for retiree healthcare benefits as of October 1, 2007, as follows:

1. If the plan remains unfunded (pay-as-you-go basis) the AAL to be recognized amounts to \$123,122,000.
2. If the plan were funded in an irrevocable trust, the AAL to be recognized amounts to \$73,688,000.

The above AAL is made up of amounts for both retired and active employees as follows:

	Unfunded Plan	Funded Plan
Retired Employees	\$55,654,000	\$35,249,000
Active Employees	\$67,468,000	\$38,439,000
Actuarial Liability	\$123,122,000	\$73,688,000

From the above, one can see that the AAL for retired employees is significant and represents the amount that should have been recognized and set aside in prior years to pay for already retired employees healthcare benefits. The above also shows that the AAL for current employees is also significant and represents the amount that should have been set-aside in the past for services rendered by employees that are currently employed.

Based on a review of the 2009 budget documents, it appears the Benefits Committee intends to finalize a plan for the 2010 budget cycle that will address funding the City’s OPEB commitment through a cost sharing mechanism between employees and the City. In relation to that plan, the above table shows that the current actuarial liability for an unfunded plan amounts to \$123,122,000. This amount represents services already rendered for benefits promised. As also shown in the next table in this report, the actuarial

accrued liability amount yet to be recognized for active employees amounts to \$60,032,000. The Committee should seek equity in its efforts to fund OPEB through employee cost sharing.

The City’s consultant also provided in their report an amount that represents the present value of future benefits. This amount is determined by estimating the cash flow of premiums expected to be paid for all active and retired employees from the point they retire to their expected lifetime and then calculating the present value of that total amount back to today. The difference between the present value of future benefits and the unfunded actuarial liability represents the amount yet to be recognized over the remaining years of service for active employees as follows:

	Unfunded Plan	Funded Plan
Present value of future benefits	\$184,154,000	\$94,291,000
Unfunded actuarial liability	\$123,122,000	\$73,688,000
Amount yet to be recognized for active employees	\$60,032,000	\$20,063,000

From the above, one can also conclude that the unfunded pay-as-you-go plan is significantly more than a funded plan where an irrevocable trust is established. The reason for this is that the actuary assumes in a pay-as-you-go plan the rate of return is 4.0 percent, representing the estimated rate of return on unrestricted general funds of the employer. Whereas, in a funded irrevocable trust plan, the actuary assumes that the long-term rate of return on trust assets would be 7.75 percent. Accordingly, an irrevocable trust is the less costly method of funding OPEB cost; however, this option also restricts contributions to only the purpose for which they are deposited. Such monies cannot be withdrawn to meet other pressing needs of the government.

At the time of the consultants October 2005 report, the City had 3,712 total participants of whom 2,783 were active participants (current employees) and 929 were retired participants. As of October 2007, the City had 3,855 total participants of whom 2,789 were active participants and 1,066 were retired participants.

Based on the above information and assuming the City continues to contribute to employee healthcare premiums upon retirement, those 1,066 employees that have already retired will each receive on average over \$50,000 in City contributions toward their health insurance premium during their retirement years. For the 2,789 active employees, the present value of benefits already earned averages over \$24,000 per employee and the present value of the amount yet to be recognized for these active employees averages an additional \$21,524 per employee.

The GFOA has stated that while GASB standards do not require employers to advance fund OPEB, governments should give consideration to advance funding in view of the effect on:

- Intergenerational equity,
- Sustainability, and
- Financial flexibility.

*Implicit Rate Considerations.* While the City is required by Florida law to establish a blended healthcare premium for both active and retired employees, GASB Statement No. 45 also requires the City to separately calculate (recognize) what the premium would be for active employees as compared to retired employees. This cost difference must be recognized as an *implicit* amount for financial statement disclosure purposes. The logic for this calculation is that current employees and retired employees do not incur similar amounts of healthcare cost - medical costs for retirees are normally significantly higher. As a result, with a blended rate, retirees are not paying for the actual costs of their benefits. This difference in rate, referred to as the implicit rate subsidy, represents the difference between what retirees pay at a blended rate as compared to what they would have paid had their rate been calculated as a separate retiree group.

Accordingly, even if the City’s healthcare program were totally noncontributory on the part of the City, there would still be an implicit rate that would have to be recognized. For purposes of this report, we estimate that approximately 55 percent of the AAL for the City can be attributed to the implicit rate.



In 2005, a similar valuation performed for the State of Florida showed that about \$3.6 billion of their AAL attributed to the implicit rate subsidy. For the State, the amount required to fund the benefit on an actuarial basis was calculated to be \$213 million per year on a pay-as-you-go basis.

**What is the Annual Required Contribution (ARC) and how is it calculated for purposes of GASB Statement No. 45?**

For financial accounting and reporting purposes going forward, GASB Statement No. 45 requires an OPEB expense to be recognized annually and systematically over periods approximating an employee’s years of service. This is referred to as the Annual Required Contribution (ARC) and is calculated by:

1. Projecting cash outflows for benefits from the time an employee will retire to his/her life expectancy;
2. Discounting the projected benefits (cash flows) to the present value (where the employee is in terms of years of service); and
3. Allocating the present value of projected benefits to actual past and expected future service periods using an acceptable actuarial cost method. The past service period is composed of the employee’s age at employment to his/her current age, and the future service period is the difference between the employee’s assumed age at retirement and his/her present age.

The difference between the AAL (actuarial accrued liability) and the actual amount currently available to meet that obligation is referred to as the UAAL (unfunded actuarial accrued liability). This amount represents the benefits employees have earned to date to be received in the future, but that has not yet been funded. Similar to pensions accounting, the annual required contribution amount is calculated such that if the employer makes each annual payment, the unfunded actuarial liability will be eliminated over a period of not more than 30 years. The reason for this is each year’s payment is made up of (1) the amount needed to pay for services rendered by the employee during the current year,

and (2) the amount needed to pay for previous years of service when cost were incurred but not paid.

In their most recent actuarial valuation, Buck Consultants presented the Annual Required Contribution for OPEB as follows:

	Unfunded Plan	Funded Plan
Normal Cost	\$5,706,000	\$2,612,000
Amortization of Unfunded Actuarial Liability	\$4,269,000	\$4,221,000
Total ARC	\$9,975,000	\$6,833,000

GFOA notes a key factor in assessing the financial health of an OPEB plan is *direction* and *speed*. The ARC can be expressed as a percentage of covered payrolls and represents the amount of employer contributions needed to amortize the unfunded actuarial accrued liability compared to employer contributions made. For employer contributions, the single right answer is 100 percent funding.

**What are the accounting and funding options available to the City to address the calculated OPEB UAAL?**

As previously noted, the unfunded actuarial liability is not presented on the face of the financial statements themselves; however, information relating to the unfunded actuarial liability is required to be disclosed in the notes to the financial statements.

Beginning in fiscal year 2007-2008, the City of Tallahassee is required to report information relating to OPEB in our financial statements. Accordingly, disclosure will be made in the notes to the financial statements about our OPEB plan to include: the UAAL, whether we have a funded (designated irrevocable trust) or unfunded (pay-as-you-go) plan, and information as to how we have funded the plan during the current year. While the AAL is not shown on the face of the financial statement, there are circumstances where we will be required to record an actual accounting liability in our financial statement.

If the City of Tallahassee contributes to our plan (either funded or unfunded) in an amount that is less than the ARC, the difference between the amount contributed and the amount we should have contributed is reported as an accounting liability in the face of the government-wide financial statements and labeled as the “net OPEB obligation.” Amounts that the City of Tallahassee may designate or set aside by designations or in separate funds do not qualify as OPEB contributions for accounting purposes. In other words, if monies are not contributed to an outside party or put in an irrevocable trust, the full amount of the expense for the period would be recognized as the OPEB liability. For each subsequent year that the liability exist and is not funded, that recorded liability amount must be increased by interest that would have been earned had the amount been invested.

Based on current GAAP, the recorded accounting liability is shown only in the Government-wide financial statements. The accounting liability does not apply to Governmental Funds financial statements because governmental funds follow a modified accrual basis of accounting that does not require recognition of over or under funding the annual required contribution.

A government’s concern should be whether bond rating agencies and citizens as a whole believe that not funding the annual required contribution does or will affect the financial stability or sustainability of the government. In other words, will the government be able to meet its service promises to future generations if it is burdened with having to pay for benefits for retirees for which the government did not fund in prior periods when services were rendered. The concern is that future generations will be burdened with cost for which they receive no service. That service was provided by employees in prior periods and the government made unfunded promises in exchange for those services.

For some governments, the way they have funded the unfunded accrued actuarial liability is by issuing debt (the City of Gainesville is an example and the city contribution is based on years of service and age and is capped at 50

percent of a single premium). According to GFOA, the objective in this arrangement is to invest the proceeds in qualified investments at a return substantially higher than the interest cost of the debt. The GFOA, in a “Recommended Practice” has noted that the UAAL is inherently more volatile than the actuarial liability for pension benefits because healthcare usage is less predictable than life expectancy, and healthcare trends are more volatile and difficult to predict. Also, state and federal healthcare initiatives might also significantly affect the way healthcare benefits are provided in the future. In addition, if the expected rate of return does not occur, the government may actually be more at risk as it will be earning a lower rate of interest on the debt proceeds than it is paying in interest on the debt.

The decision to advance fund OPEB by issuing debt requires a government to carefully analyze its particular financial situation. In some instances it may be better in the long term to establish an irrevocable trust even though the government may not be able to initially fully fund the annual required contribution. In summary, GFOA recommends that governments exercise considerable caution when contemplating the possibility of issuing OPEB bonds.

***What is the long-term cost to the City when a promise is made to subsidize an employee’s healthcare at retirement?***

First of all, as implemented by the City, there is no relationship between (1) the level at which an employee is paid and the amount the City has agreed to subsidize the employee’s healthcare cost in retirement, or (2) once vested, the differing lengths of employee service and the City contribution at the time of retirement. Therefore, currently the healthcare subsidy the employee receives at retirement is for all practicable purposes the same without regard to an employee’s salary or length of service.

As previously noted, as of October 1, 2007, and depending on whether the City takes a pay-as-you-go approach or decides to establish and fund an irrevocable trust going forward, the accrued actuarial liability of OPEB is between \$73 and \$123 million.

To place this benefit into perspective, the following table is presented to show the expected benefit that would be received by one City special risk employee (an example is a law enforcement officer) and one general city employee if that employee were to retire today and the employee received the projected health insurance subsidy for the remainder of his/her life.

Description – Two Party Coverage	Special Risk Employee – Annual Premium Subsidized by City from age 50 to age 82 (32 years)	Other city employee - Annual Premium Subsidized by City from age 62 to age 82 (20 years)
City Total Contribution Assuming Employee is Medicare Eligible at age 65	\$125,000	\$35,000

As shown above, over the 32 retired years of a special risk employee that retires at age 50 with 25 years service, the cash outflow for insurance premium contributions by the City would total approximately \$125,000, should the employee retire in 2008. Stated differently, the present value of future benefits for all employees (both special risk and other employees that are either active or retired) amounts to \$184,154,000 as of October 1, 2007 (the date of the actuary study) or approximately \$50,000 per employee.

The reason that the City contribution is significantly more for a special risk employee as compared to other employees is that the period of time prior to a special risk employee being Medicare eligible is significantly longer. The City contribution for Medicare eligible employees is significantly less than for employees not eligible for Medicare.

In January 2008, the Comptroller General of the United States, as the head of the Government Accountability Office (GAO), reported to Congress that state and local governments have several growing fiscal challenges. One of the

challenges identified by GAO was healthcare cost for state and local employees and retirees. Based on their study, active employees’ expenditures on healthcare amounted to 12.8 percent of wages in 2006. Their prediction of the percentage of healthcare compared to wages by 2050 ranged from a low of 13 percent to a high of 37.7 percent and most likely will be 22.2 percent of wages.

Accordingly, one of the key factors of employer costs when they contribute to employee healthcare premiums is the rate at which those premiums will increase. It is likely that in the future, healthcare cost will continue to increase at a greater rate than inflation. Consequently, the premium amounts paid by the employees and the City in 2008 will increase significantly in future years.

For current and retired employees, the current blended monthly premium is shown below along with the monthly premium amount paid by employees and paid by the City. As previously noted, neither the State of Florida nor Leon County subsidizes retiree healthcare costs.

**2008 Healthcare Rates**

Active Employee	Employee Pays	City Subsidy	Total Monthly Premium
Employee Only	\$ 62.08	\$ 320.65	\$ 382.73
Employee + 1	\$ 167.70	\$ 598.66	\$ 766.36
Family	\$ 329.98	\$ 718.33	\$1,048.31
Retirees	Employee	City	Total
Individual	\$ 226.41	\$ 156.32	\$ 382.73
Two-Party	\$ 481.22	\$ 285.14	\$ 766.36
Three or More	\$ 649.93	\$ 398.38	\$1,048.31

The above table shows that the total healthcare premium for both active and retired employees is the same as required by Florida Statute. For purposes of this report, the above table also shows that the City subsidizes healthcare cost for retirees in amounts ranging from \$156.32 to \$398.38 per month depending on persons in the household eligible for coverage. Based on the above table for retirees, the annual value of this City subsidy in 2008 ranges from \$1,875.84 to

\$4,780.56 per year, with the two party subsidies amounting to \$3,421.68 per year.

As one might expect from a blended rate, if the total premium is the same for both active and retired employees, that also means that the total premium is the same whether an employee chooses an HMO, currently Capital Health Plan (CHP), or Blue Cross/Blue Shield (BC/BS). In fact, the unblended premium for CHP compared to BC/BS is significantly different.

The following table shows the current premium for a retiree that becomes Medicare eligible:

<b>Retiree - Medicare CHP</b>	<b>Employee</b>	<b>City</b>	<b>Total</b>
Individual	\$ 129.28	\$ 32.32	\$ 161.60
Two-Party (Both Medicare)	\$ 261.79	\$ 61.41	\$ 323.20
Two-Party (One Medicare/ One Not)	\$ 361.35	\$ 162.35	\$ 523.70
Three or More (One or two Medicare)	\$ 565.22	\$ 265.98	\$ 831.20
<b>Retiree - Medicare BC/BS</b>			
<b>Retiree - Medicare BC/BS</b>	<b>Employee</b>	<b>City</b>	<b>Total</b>
Individual	\$ 249.90	\$ 159.78	\$ 409.68
Two-Party (Both Medicare)	\$ 525.65	\$ 336.07	\$ 861.72
Two-Party (One Medicare/One Not)	\$ 525.65	\$ 336.07	\$ 861.72
Three or More (One or two Medicare)	\$ 724.80	\$ 463.39	\$1,188.19

The above table shows that for retirees eligible for Medicare, the CHP program is significantly less expensive for both the City and the employee. Even so, employees in the CHP program, as a result of a blended rate, subsidize the premium of retirees that choose the BC/BS plan. Our analysis shows that on an unblended rate basis, BC/BS retirees actually pay less than 40 percent of the actual cost of coverage. Fortunately, only a very small percentage of retirees have chosen the BC/BS option. Where possible, the City should provide incentives for these employees to use the CHP option. We have

been informed in response to our inquiry that the BC/BS option is generally selected by employees that, upon retirement, leave the area and permanently relocate. The vast majority of retirees that continue to live in the Tallahassee area choose to stay with CHP.

Please note from the above table, for example, individual retiree healthcare cost for CHP (Capital Health Plan) totals \$161.60 monthly; whereas, coverage under BC/BS would be \$409.68 per month, or \$248.08 more per month than the CHP plan.

Notwithstanding the above and separate from OPEB, City employees do receive a separate and additional healthcare benefit upon retirement that is based on years of service with the City at the time of retirement. This benefit is not related to the City subsidy of the employee’s healthcare cost. The benefit is a monthly payment of \$5 for each year of service. For example, an employee that retires from the City with 30 years service will receive a \$5 per month benefit for each year of service prior to retirement, or \$150 per month. This annual benefit of \$1,800 is separate and in addition to the employee’s calculated pension benefit. For purposes of funding, this benefit is included in pension plan calculations and is not part of OPEB.

**Conclusion**

Like many other cities, the City of Tallahassee has historically promised future healthcare benefits to employees when they retire in exchange for services provided during the employee’s service period. With the issuance of GASB Statement No. 45, the City will now have to recognize the cost of those services when there is an exchange of benefits for services. As a result, the 2008 City financial report will include disclosure of the unfunded actuarial accrued liability amounting to over \$120 million based on our current pay-as-you-go plan. The City Employees Benefits Committee has been working for some time to develop a strategy to address how to fund and account for this actuarial liability going forward. Progress has been made and significant issues are yet to be resolved. In that a strategy is currently being developed, we

recommend that the Committee continue to move forward, to consider available alternatives identified by them and ones provided by the Office of the City Auditor, and to present their recommendations to the City Commission for review, discussion, and direction for the 2010 budget year.

### ***Appointed Officials' Response***

The City Treasurer-Clerk and City Manager appreciate the comprehensive OPEB review completed by the City Auditor. As stated in the audit, the City Employee Benefits Committee has been working with DMA for some time to develop a strategy to insure that the City is in compliance with all GASB 45 requirements. We plan to present at the next meeting of the Financial Viability Target Issue Committee a recommended implementation plan. We would like to accentuate the following points related to the GASB requirements.

First, GASB 45 does not change the postemployment benefits being provided to City employees, but is only a change in accounting procedures that requires governmental entities to recognize the cost of providing such benefits. Postemployment benefits provided by the City are part of a total compensation package provided to our employees. The City's Employee Benefits Committee continually monitors on a comprehensive basis the benefits and compensation package offered to our employees and annually recommends changes if warranted. Like most governments/employers, the City has historically funded postemployment benefits on a pay-as-you-go basis. The issue now facing the City is whether to continue to fund the benefits on a pay-as-you-go basis or to fund the benefits as they are earned. GASB 45 does not specify a particular method for *funding* of OPEB.

There are many factors that must be considered in evaluating the different funding options. For example, the State of Florida requires cities to set the health insurance premium for retirees and active employees at the same level. GASB 45 states that the cost of health insurance for retirees should be higher than that those for active

employees. GASB 45 also states that having the same premium for employees/retirees creates an implied postemployment benefit that must be recognized. Of the City's \$123 million unfunded actuarial liability, \$67 million (over half) is the result of the implied benefit. Since the accounting for the implied benefit would be to increase the City's cost for retirees' insurance and reduce the City's cost for active employees' insurance by the same amount, there is no net effect on the City's budget. Because there is no net effect on the operating budget, Tallahassee may choose not to fund the implied benefit. While this decision has not yet been made by Tallahassee, many Governmental Entities including the State of Florida, Leon County and the City of Gainesville are not funding the implied benefit.

We agree with the City Auditor's recommendation that the Employee Benefits Committee consider alternatives and present recommendations to the City Commission for FY 2010. This was also recognized in the budget process by the Office of Budget and Policy's recommendation that a funding method be identified in next year's budget cycle. City staff continues to gather information and will use all available information to make a comprehensive recommendation. For example, the Employee Benefits Committee has been aware of the total UAAL for some time, but only recently received the actuarial report that over half of the liability results from the implicit subsidy (i.e., that portion required by State statute and beyond City control). This and other factors will be fully evaluated before making a final recommendation to the Commission.

## Other Postemployment Benefit Key Terms (provided by the GFOA)

**AAL – Actuarial accrued liability.** The present value of projected future benefits earned by employees to date.

**Actuarial valuation.** A process used by actuaries to (1) project future benefit payments, (2) discount those payments to their total present value, and (3) systematically allocate an appropriate proportion of that amount to each period of employment using an acceptable method.

**ARC – Annual required contribution.** The portion of the cost of projected benefits earned by employees attributed to the current period.

**Blended premium.** A healthcare premium that does not take into account the age of the individuals covered, as when a single premium is used for both active and retired employees.

**Implicit rate subsidy.** The *de facto* subsidy of retirees by permitting them to pay lower than age-adjusted premiums through the use of a single common or blended rate for both retirees and active employees.

**Net OPEB obligation.** Accounting liability created when an employer does not fully fund its annual required contribution for OPEB.

**OPEB – Other post-employment benefits.** All types of post-employment benefits not offered as an integral part of a pension plan, as well as all forms of post-employment healthcare.

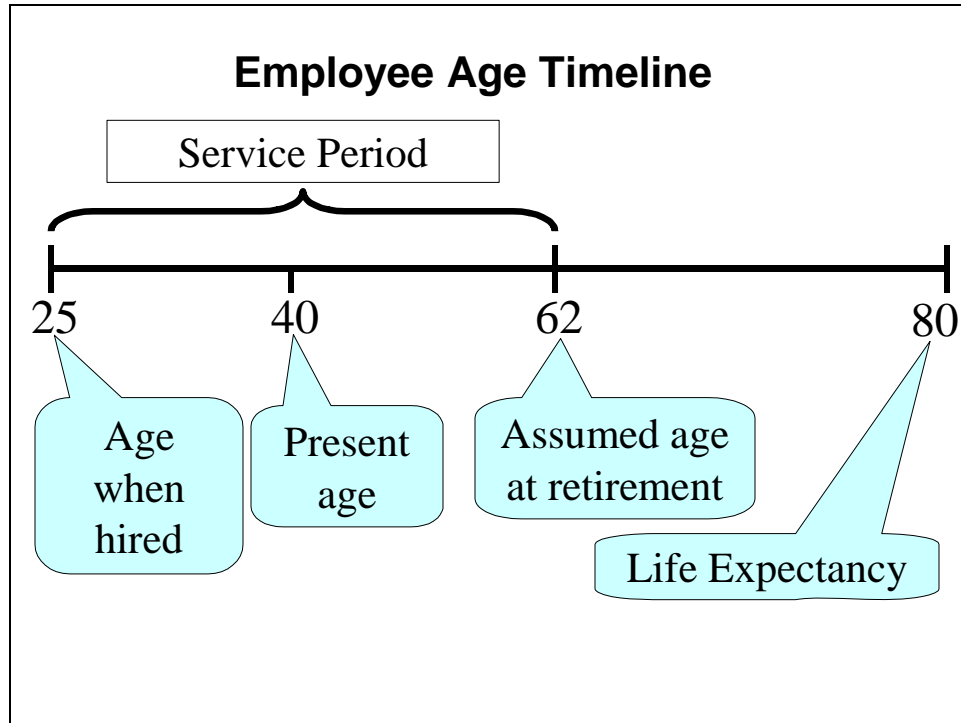
**Pay-as-you-go funding.** A method of financing benefits by making required payments only as they come due.

**Postemployment benefits.** Payments made directly to former employees or their beneficiaries, or to third parties on their behalf, as compensation for services rendered when they were still active employees.

**UAAL – Unfunded actuarial accrued liability.** The difference between the actuarial accrued liability and the actuarial value of assets accumulated to finance that obligation.

**Vested benefits.** Benefits earned by employees that are in no way dependent on their continued employment.

Exhibit 1

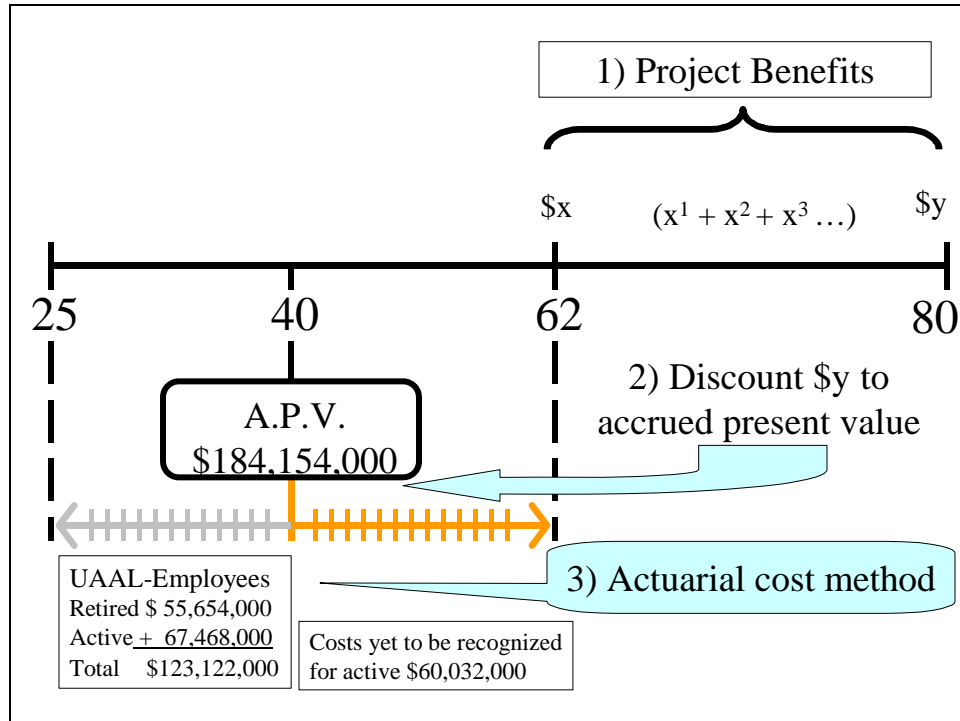


Source: Modified from presentation provided by GASB staff

As it relates to OPEB (Other Postemployment Benefits), the above shows the following for an example employee:

1. The employee was age 25 when hired and his/her present age is 40, representing 15 years of service already provided.
2. If the employee works until an assumed age of 62 at retirement, the employee will work another 22 years for a total service period of 37 years.
3. The difference between the employee's life expectancy of age 80 and the employee's assumed age of 62 at retirement, or 18 years, represents the OPEB period.
4. For the City, OPEB represents an exchange of benefits for services. That cost should be recognized at the time services are rendered and annually over the employee's service period. If funds are systematically set aside in an irrevocable trust over the employee's service period, sufficient monies should have accumulated at the employee's assumed age at retirement, age 62, that would fully fund the City's OPEB contribution during the employee's retirement years to age 80.

### Exhibit 2 Calculating the OPEB Accrued Present Value and Allocation of Costs to the Prior and Future Service Periods



Source: Modified from presentation provided by GASB staff

**As it related to OPEB (Other Postemployment Benefits), the above shows how the APV (Accrued Present Value) is calculated and assigned to plan service periods.**

1. Projected benefits ( $x^1 + x^2 + x^3 = \$y$ ) are calculated by determining the sum of the City contribution for each year healthcare will be provided to include projected annual premium increases. In the example, projected benefits occur from age 62 to age 80.
2. The accrued present value of projected benefits is determined by discounting the sum total of project benefits ( $\$y$ ) back to the average age of the workforce. In this example, one assumes the average age of the workforce is 40. Therefore, the accrued present value of total projected benefits ( $\$y$ ) for the City of Tallahassee discounted to age 40 is \$184,154,000.
3. Since the City has not to date set aside any funding for the promised City contribution and is currently on a pay-as-you-go plan, the entire amount of \$123,122,000 is recognized as the UAAL (unfunded actuarial accrued liability). As shown above, this amount applies to services already rendered by retired and active employees in the amount of \$55,654,000 and \$67,468,000 respectively. According to GASB, this UAAL amount of \$123,122,000 should be expensed over a period not to exceed 30 years.
4. Cost to be recognized in the future and yet to be funded (age 40 to age 62) amounts to \$60,032,000 for the City. This amount should be systematically expensed each year from age 40 to age 62. This amount represented the APV of cost yet to be recognized for active employees.

Copies of this Audit Report #0819 may be obtained from the City Auditor's website (<http://talgov.com/auditing/index.cfm>) or via request by telephone (850 / 891-8397), by FAX (850 / 891-0912), by mail or in person (Office of the City Auditor, 300 S. Adams Street, Mail Box A-22, Tallahassee, FL 32301-1731), or by e-mail ([auditors@talgov.com](mailto:auditors@talgov.com)).

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