

Public employers that face the new Governmental Accounting Standards Board's Statement No. 45 (GASB 45) accounting rules in 2007 can learn some valuable lessons from the private sector firms that encountered similar accounting changes under 1993's Financial Accounting Standard (FAS) 106.

# Effect of New *GASB 45* Accounting Rules:

## *What We Can Learn From FAS 106*



by **Martin Feldman and  
Roscoe Haynes**

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**P**ublic employers are subject to new accounting rules for retiree medical benefits starting this year. GASB 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, requires public employers to account for the cost of other postemployment benefits over the active service life of employees, instead of on a pay-as-you-go basis.

Since the new rules were promulgated

in 2004, increasing attention has been paid to the potential impact on public employers and their retiree medical benefit programs. For large public employers such as state governments, liabilities for these benefits can be billions of dollars. Even for smaller employers like local school districts, the liability can be substantial compared to the pay-as-you-go method that finances most retiree medical plans.

Although rising medical costs certainly have been a source of concern for many

years, retiree medical plans add a new wrinkle. Paying for medical costs one year at a time for active employees is one thing, but recognizing the cost of future medical benefits to retirees—both current and future—is a new factor that public employers face.

There is great concern about the effect of these new accounting rules. How will they affect an employer's budget and financial statements? Will the disclosure of liability affect credit ratings and ability to borrow? Will it cause employers to reconsider their ability to provide these benefits to their employees and retirees? Will employers drastically cut back these benefits or terminate these plans entirely?

While compliance with these accounting rules is new for public employers, it is not new for both small and large U.S. corporations. These corporations became subject to similar accounting requirements under FAS 106 beginning in 1993; they have already encountered all of these issues over the last ten to 15 years. An examination of the aftermath of the adoption of FAS 106 on U.S. corporations can provide useful insight for public employers today.

## Background

Retiree medical benefits were first provided by major U.S. corporations in the 1960s or earlier. Most companies had relatively few retirees when they began offering these benefits, and the prospective liabilities were not known or examined. For many, the amount spent for retiree medical benefits was not even identified and was frequently lumped in with medical benefits for active employees in a company's financial statements. As medical costs skyrocketed in the 1980s, the number of retirees for many companies increased and the potential liabilities loomed large, the Financial Accounting Standards Board began a project to require accounting for these benefits. Public attention increased as an exposure draft was published in 1989 and reached a high point when FAS 106 took effect in 1993.

FAS 106 required companies to report their retiree health care costs on an accrual basis rather than the previous pay-as-you-go cost basis. The recognition of these costs had the potential to reduce a corporation's net income.

As major corporations commissioned actuarial studies and learned the magni-

tude of the liabilities of their plans, companies had to address the effect of the new rules on their financial statements and on these benefit plans. Several areas were investigated: Since most plans were handled on a pay-as-you-go basis, should advance funding be considered? Could companies afford to continue these benefits in their existing form? What plan design changes or cost-control measures could be used? Were there ways to address the accounting requirements to ameliorate the financial impact?

All of these issues are now a factor for public employers that offer retiree medical plans. A review of the many approaches taken by U.S. corporations in dealing with FAS 106 may be instructive.

## Plan Design

FAS 106 led many companies to examine the provisions of their medical plans to see whether they accomplished corporate objectives for providing benefits to employees and retirees. For example, some plans offered the same medical benefits to both an employee who retired with ten years of service and an employee who retired with 30 years of service. In reexamining that design, some employers began to tie their medical benefits to length of service with the company, as is the case with many pension benefits. Perhaps medical benefits would be provided without any contribution by the retiree after 30 years of service, but employees who retired with fewer than 30 years of service would pay part of the cost, graded by service length.

Other plan elements that came under examination were the provision of full benefits to spouses at no cost, the provision of full benefits at younger retirement ages and the level of medical benefits provided. Some companies wanted to concentrate their benefit dollars on retirees and cut back on benefits for spouses, as many spouses were employed and had medical coverage from their own employers. Other companies opted to protect their retirees from catastrophic events but ask retirees to pay for basic, day-to-day medical coverage. Some companies determined that Medicare was sufficient after the age of 65 except for prescription drug coverage (which was not part of Medicare in the 1990s) and changed their plans to provide only prescription drug coverage after the age of 65. Another approach was to cap the amount the company would

pay toward medical coverage, although in some cases this was more of an accounting device, as this article will further discuss.

## Accounting

Booking a liability for future retiree medical benefits, including the effect of future medical inflation, or trend, was an eyeopener for many companies. In the late 1980s and early 1990s, medical inflation was running in the double digits, often 15% to 20% a year or more. While this presented a problem that was significant in its effect on companies' medical costs for active employees, when translated to accrual accounting for retiree medical plans, the numbers were astronomical. Of course, many actuaries, economists and other analysts opined that medical inflation at double-digit percentage increases could not continue indefinitely, so liabilities at first were generally determined using a higher medical trend assumption that then ramped down to a more "reasonable" level over the next five to ten years. Even this approach, however, left companies with huge liabilities that would need to be expensed and would appear as footnotes on their financials.

Other approaches were considered to mitigate this impact. A common one was to introduce a *cap* on the amount the employer would contribute toward medical benefits for retirees. For example, say the average per capita cost of medical benefits in 1993 for coverage for Medicare-eligible retirees was \$150 per month. A cap on future costs at the level of double 1993 costs would mean that when the average cost reached \$300 per month, future inflationary increases would be the responsibility of the retiree. If medical inflation was at 10% per year compounded, the \$300 level would be reached in about seven or eight years. This approach had two major advantages:

1. It meant a significant reduction in liabilities and expense, since future medical inflation would only be factored into the liability for seven or eight years.
2. It had no immediate impact on current retirees or those retiring during the next five years or so, giving the company some time to analyze

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other approaches and attempt to get medical costs under control.

### **Continue the Plan?**

As companies focused on the extent of the liabilities and costs of retiree medical programs, some considered discontinuing them entirely or ending participation for future retirees or new hires. In the public sector, this may not be an acceptable approach in many instances, such as situations in which benefits are the subject of collective bargaining. Also, the public sector traditionally has a pattern of lower pay/better benefits compared to the private sector. But much of corporate America was also reluctant to take drastic steps. With medical costs on the rise, companies had to weigh the effect on their bottom line against a concern about retirees' ability to cover their medical bills. From a human resources point of view, companies also wanted to make sure that their employees would be able to retire and make room for a younger workforce.

This dilemma frequently resulted in various compromises. For example, some companies discontinued the retiree medical program for employees younger than the age of 40 or for employees whose age added to years of service totaled less than 75 years. However, those companies that could not remain competitive without trimming costs opted to terminate coverage for all future retirees, or even for existing retirees.

### **Substitute Benefits**

Some corporate employers, feeling compelled to eliminate or reduce their enormous unfunded retiree medical liabilities, looked to pension benefit increases to offset the impact of retiree medical plan cuts. In the late 1980s and 1990s, many pension plans were well-funded as a result of favorable investment returns. Further, the additional liability created by these pension increases could be spread over a 30-year amortization period. Pension benefits could be substituted for retiree medical benefits with little or no increase in current pension contribution requirements.

However, these substitute benefits rarely replaced the full value of the lost retiree medical benefits. The new pension benefits were usually fixed monthly

amounts, while retiree medical benefits typically increased annually. And while pension benefits were generally taxable to the employee, retiree medical benefits were not. In fact, retiree medical benefits are considered one of the most tax-efficient approaches to providing significant value to retirees.

On the other hand, this substitution approach provided a much higher degree of benefit security. A retiree medical program was generally unfunded and would be one of the first benefits to be forfeited in the event of bankruptcy or other financial distress. In contrast, the pension benefits were funded and both benefits and assets were covered by the rigorous protective fiduciary rules of the Employee Retirement Income Security Act (ERISA).

### **New Approaches**

Benefit plan approaches continued to evolve, even after the FAS 106 compliance process concluded. The employers now faced with GASB 45 planning have several new options to choose from as they modify their existing benefits programs.

#### **Consumer-Directed Health Plans**

Consumer-directed health plans (CDHPs) are a new approach that is gaining adherents among U.S. employers. CDHP participants are given more responsibility for selecting and managing their benefits. Employees choose their respective plan options and then determine how to distribute their total benefit contribution among their chosen benefits.

A common CDHP arrangement couples a high-deductible catastrophic insurance plan with a health reimbursement arrangement (HRA) or a health savings account (HSA). The high-deductible component covers high-severity or catastrophic health care services, while the HRA or HSA covers more commonplace services such as visits to the doctor's office.

The HRA or HSA is provided by the employer and pays for a specified amount of out-of-pocket medical expenses, as defined by the employer (HRA) or IRS statute (HSA). HRAs and HSAs allow employees to roll over any unused amounts to help cover health care expenses in subsequent years. Unlike flexible spending accounts, in which unused balances are lost at the end of the year, this HRA or HSA rollover provision actually rewards participants for seek-

ing out less costly health services. By giving individuals a more active role in their own benefits plans, the CDHP model encourages employees to make more informed decisions about overall health care.

Although CDHPs have been used primarily for active employees in an attempt to control the rising medical costs that employers are facing, they are just as effective for retiree medical plans.

#### **Medicare Advantage**

Another option employers have begun to use is Medicare Advantage, which was known as Medicare+Choice prior to 2006. Under Medicare Advantage, available only to Medicare-eligible retirees, retirees can opt out of the standard Medicare program in favor of health maintenance organizations (HMOs) or other private health insurance plans that qualify as Medicare Advantage programs. These plans typically provide more extensive benefits than those from Medicare, at little or no cost to the retiree. However, Medicare Advantage plans are funded by special appropriations from the Medicare program. If at some point in the future a sponsoring HMO or insurance company finds that the cost of providing the benefits is greater than the amounts received from Medicare, the benefits may be discontinued.

#### **Defined Contribution Plans**

Defined contribution (DC) plans provide an alternate way to structure the medical benefits provided to retirees. Unlike a traditional defined benefit (DB) plan, which provides a specified level of benefits, a DC plan defines the contribution an employer makes toward each retiree's coverage. The retiree uses the employer contribution, which can vary according to years of service at retirement and Medicare status, to help finance benefit coverage.

This approach works best for Medicare-eligible retirees who can purchase Medicare supplement policies on the open market and also enroll in Medicare Part D for prescription coverage. Options for retirees under the age of 65 are limited to individual policies that can be costly or provide only limited benefits. Medical plans may use the DB or DC approaches separately or in some combination, such as DB for early retirees and DC for Medicare-eligible retirees. An expansion of the DC concept provides contributions

to an active employee account that accumulate and are used in retirement to pay for benefits.

Newer alternatives like CDHPs and DC plans were not readily available when companies first complied with FAS 106. But companies with retiree medical plans that are subject to GASB 45 accounting rules may be able to use some of these recent additions to their advantage.

### Lessons for Public Employers

Private sector companies that developed successful compliance strategies to deal with FAS 106 did so by carefully assessing their own benefits systems and then systematically addressing the new requirements. Their experiences provide valuable lessons for public employers today.

Diagnostic techniques and benefits strategies that proved useful then can now be used by employers striving to comply with GASB 45. Steps to be taken include:

- Gather in advance as much information about the retiree medical plan as is available, including plan descriptions, participant data and claims experience.
- Commission a study of the plan's liabilities and the expense under GASB 45 as soon as practicable. Don't wait for the effective date of the new accounting rules.
- Review the retiree medical plan in conjunction with benefits and human resource objectives. Analyze medical

costs for active employees as well. It is rare that the retiree medical benefit program can be considered on its own.

- Examine other approaches to providing medical benefits, including DC approaches and CDHPs.
  - Don't be dismayed at the astounding liability you may see when a value is placed on the benefits. Instead, make benefits decisions that will meet both financial and employee needs in the long term.
- GASB 45 rules present a host of new re-

quirements that may lead public employers to curb their medical benefit contributions or even change the overall structure of their health plans. These employers must eventually find a way to manage the rising costs of providing benefits to both active employees and retirees. A thorough analysis of the corporate sector's experience with FAS 106 can help employers successfully meet this challenge. **B&C**

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**Martin Feldman, FSA, MAAA, EA**, is a former principal and consulting actuary for Milliman. During his 22 years at the firm, he specialized in pension and retiree medical programs. Feldman assisted clients in areas of plan design, liability and cost projections; compliance with ERISA requirements for funding, reporting and disclosure; and communication and administration of employee benefit programs. He has worked with clients on their retiree medical and life insurance benefits, including valuing liabilities, determining annual expense under FAS 106 accounting requirements and plan design.



**Roscoe Haynes, FSA, MAAA, EA**, is a principal and consulting actuary with the Albany, New York office of Milliman. He has primary consulting responsibility for numerous clients, including single employers and multiemployer plans that provide retirement and retiree health benefits. His consulting activities include the design, valuation and administration of retirement programs. Haynes serves as enrolled actuary for numerous multiemployer pension funds, primarily in the construction and health care industries.

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