



BEST PRACTICE

Considerations for Prefunding OPEB Obligations (2008) (BUDGET and CORBA)

Background. Employee compensation packages for active workers often include healthcare and similar benefits following the completion of active service. Generically, such benefits are described as *other* postemployment benefits (OPEB) to distinguish them from pensions.¹ For many years, employers have been required to recognize expenses for the cost of pension benefits as those benefits are earned by employees during their active service life. The Governmental Accounting Standards Board (GASB) has now extended this same requirement to OPEB, in GASB Statement 45.²

An actuarial accrued liability for OPEB can result from an employer's obligation to provide *explicit* benefit payments (e.g., the employer will pay a percentage of retiree healthcare premiums or the employer will pay a fixed dollar amount toward retiree healthcare premiums) or from an *implicit* rate subsidy (i.e., retirees are allowed to pay the same rates as active employees, even though their age-adjusted premium would have been higher). For financial reporting purposes, both situations are treated identically. That is, the cost of the benefit is actuarially allocated to each period in the form of an annual required contribution (ARC). An employer's failure to fully fund the ARC results in an accounting liability (i.e., *net OPEB obligation*) in financial statements prepared using the accrual basis of accounting.

OPEB involving explicit benefit payments share the essential characteristics of pension benefits. Both are highly resistant to changes that would reduce current benefit levels. In the case of OPEB arising in connection with an implicit rate subsidy, the level of benefits for retirees will mirror changes in active employee benefits. This fact is important because employers have been known to change healthcare benefits for active employees in response to the budgetary challenge of increased healthcare costs (e.g., increases in deductibles, increases in employee contributions, changes in covered services). Accounting standards, however, require actuaries to assume that current healthcare benefit levels will remain unchanged for purposes of calculating the actuarial accrued liability for OPEB, including those benefits resulting from an implicit rate subsidy.

Recommendation. The Government Finance Officers Association (GFOA) recommends that the financing of postemployment benefits as they are earned (i.e., prefunding v. pay-as-you-go funding) offers significant advantages from the vantage point of equity and sustainability. Just as important, the earnings on the resources thus accumulated will lower the amount that ultimately must be budgeted by the employer.

GFOA strongly recommends that OPEB involving explicit benefit payments be prefunded on an actuarial basis, as discussed in GFOA's Best Practice, *Ensuring the Sustainability of Other Postemployment Benefits*.

GFOA believes that the prefunding of OPEB resulting from an implicit rate subsidy also is desirable. Prefunding provides equity among generations of taxpayers, levels annual retiree healthcare costs and helps ensure sustainability of the benefit. At the same time, GFOA recognizes that maintaining pay-as-you-go funding or

¹ Some government employers choose to augment other elements of employee compensation rather than providing OPEB.

² See GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (2004). The Financial Accounting Standards Board (FASB) has required the same of private sector employers since the implementation of FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, which was released in 1990 and first took effect for calendar fiscal year 1993.

prefunding an amount less than the annual required contribution (ARC) may be appropriate in some situations, given the greater likelihood that benefit levels will be adjusted over time to counterbalance, at least in part, the effects of healthcare inflation.³ If a government does decide to prefund less than the ARC each year, the level of funding selected should be explained and documented following appropriate consultation with legal counsel and actuaries.

Approved by the GFOA's Executive Board, October 17, 2008.

³ While the actuarial valuation takes into account plan design changes that have occurred since the last valuation, they can not take into account prospective changes that may occur as governments adjust the plan design of active employees to take into account budget constraints and industry changes. This is particularly relevant in cases where the OPEB liability results from retiree participation in an employer group plan, which includes active employees and is subject to ongoing benefit changes.