TO:       HONORABLE CITY COUNCIL
ATTENTION:    FINANCE COMMITTEE
FROM:   CITY MANAGER       DEPARTMENT: ADMINISTRATIVE SERVICES
DATE:   AUGUST 2, 2005       CMR: 318:05
SUBJECT: OVERVIEW OF FINANCIAL REPORTING FOR POSTEMPLOYMENT BENEFITS PLANS OTHER THAN PENSIONS – GOVERNMENTAL ACCOUNTING STANDARDS BOARDS STATEMENTS NO. 43 & 45

This is an informational report and no Council action is required.

BACKGROUND
The purpose of this report is to provide the Council with an overview of the premise and implementation requirements of Governmental Accounting Standards Board’s (GASB) Statement No. 43, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans, and Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.

The new statements are similar to previous GASB guidance for pensions. In addition to pensions, governments offer other postemployment benefits (OPEB) such as healthcare. The basic premise of the two statements is to measure and report the long-term costs of non-pension retiree benefits, with the idea that these benefits are a form of employee compensation that should be recognized as an expense as the employee earns them.

The City employs approximately 1,090 full-time current employees and it has 565 eligible retired employees. The City provides medical insurance coverage through the Public Employees Retirement System (PERS). The City has a two-tiered medical benefit plan based on date of hire. Palo Alto Police Officers Association (PAPOA) does not participate in the two-tiered plan. The current agreement with PAPOA expires on June 30, 2007 and staff will negotiate for a two-tiered plan at that time.

Employees hired before January 1, 2004 qualify for lifetime medical benefits if the following apply:

- Employee is vested in the CalPERS system (five years combined service in CalPERS agencies), and
- Employee retires from the City of Palo Alto
- In addition, an employee’s spouse receives 55% coverage, increasing by 5% for each year of service by the employee until 100% coverage is achieved.
Management and professional employees, International Association of Firefighters (IAFF) and Fire Chiefs members hired after January 1, 2004, and Service Employee’s International Union (SEIU) members hired after January 1, 2005, have the following benefits upon retirement:

- Employees with ten years of CalPERS service, at least five of which are at the City of Palo Alto, receive 50% of the lifetime medical benefit.
- Employees receive an additional 5% of the benefit for each year of service after the first ten, until 100% eligibility and 90% of their dependent coverage is achieved.

Currently, the City uses a pay-as-you-go approach. It draws from a Retiree Health Benefits Internal Service Fund, which is funded by the General Fund and Proprietary Funds (Utilities and Internal Service Funds) for current year expenditures. In 2003-04, expenditures for retiree health care for all funds totaled $2.8 million. As of June 30, 2004, the Retiree Health Benefits Internal Service Fund had a balance of $18.1 million, the majority of which was funded from General Fund.

**DISCUSSION**

*GASB 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* requires an actuarial valuation every two years to calculate the amount of annual contributions (the expense recognized in the financial statements) that would be needed to provide the promised benefits. The actuarial calculates the following:

- Actuarial Accrued Liability (AAL). The AAL is the present value of projected future benefits for all current and future retirees.
- Actuarial Value of Assets (AVA). The AVA is the market-based value of plan assets and is only taken into consideration if they are in an irrevocable trust.
- Unfunded (Actuarial) Accrued Liability (UAL). The UAL is the difference between the AAL less the AVA, in other words how much more must the City recognize as an expense to be able to fully fund its other postemployment benefit.
- Annual Required Contribution (ARC): The ARC is calculated by adding the normal cost amount (value of benefits earned in the current fiscal year) to the amortized past service amount (UAL). The maximum acceptable amortization period for an OPEB plan’s UAL is thirty years. To calculate the ARC, the actuary uses cost methods and assumptions allowable under GASB 45, such as turnover, retirement age, mortality, healthcare cost trend data and entry age.

If the City contributes the ARC to the plan every year, a liability will not be recorded. If the ARC is not fully funded in a given year, a liability is reported for the unpaid portion of the ARC. The City is in the first phase of implementation and the actuarially determined expenses will be included in the CAFR for 2007–08.

*GASB 43, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* addresses the financial statement requirements for OPEB held in a trust fund. The trust fund could be on the financial report of the plan sponsor, employer, PERS, or other third party.
Currently, GASB Statement No. 43 does not apply to the City, since the City does not currently have a trust fund for OPEB.

Preparation for Implementation:
The City has contracted for an actuarial study based on 2003-04 data. This actuarial study will provide a baseline to establish the ARC. In addition to allowable GASB methods, the City has required that the actuarial also report results using the following criteria: over and under age 65, by fund, by department, by bargaining unit, current employees, retired employee and survivors, and different amortization periods. The actuarial will also provide strategies for funding and reducing costs. The resulting report will provide a useful analytical and management tool. The report will be available by mid-year of 2005-06 with results reported to Council in early calendar year 2006.

Once a baseline is established, staff will look at options for reducing the liability, if needed, before the implementation date. Such options might be to cut spending, change the benefit package, and/or establish a trust.

Establishing a trust means that plan assets are dedicated to providing benefits to retirees in accordance with the terms of the plan and are legally protected. If the City chooses to establish a trust, the following must be considered:

- An irrevocable transfer of assets to a trust means the employer loses access to those funds permanently or until the plan is terminated.
- Plan assets in a trust lower the ARC, thereby lowering the cash contribution from the City.
- Using a trust allows different investment options such as investment in equities and longer-term maturities, possibly lowering additionally the cash contribution from the City.
- GASB Statement No. 43 requires reporting on the trust fund in the 2006-07 CAFR.
- A separate audit may be required.

Additional information must also be included in the notes of the CAFR. Examples of the information included in the notes are:

- Plan description
- Funding policy
- Information regarding the actuarial valuation
- Net OPEB obligation, if one exists

Staff will report in the early part of calendar year 2006 to discuss the results of the actuarial study.

**ENVIRONMENTAL REVIEW**
The action recommended is not a project for the purposes of the California Environmental Quality Act.