Washington State Auditor
Brian Sonntag

Date: January 21, 2008

To: Local Governments Reporting on the GAAP basis

Subject: Using the Alternative Measurement Method for Other Post Employment Benefits Reporting

Over the next three years, local governments reporting on the Generally Accepted Accounting Principles (GAAP) basis will have to begin reporting their liability for Other Post Employment Benefits (OPEB) in their financial statements. OPEB includes all benefits (other than pensions) promised to retirees. These new requirements for the financial statements are the result of Statement No. 45 that has been adopted by the Governmental Accounting Standards Board (GASB). In most cases, an actuary will be needed to calculate these future benefits.

The State Auditor's Office and the Office of the State Actuary have reviewed GASB Statement 45 in an effort to determine a way for entities to avoid the costs of an actuary and still comply with the new standard. Entities with the following types of plans may be able to minimize costs using the following options.

1. Entities with plans of fewer than 100 members may use the alternative measurement method to calculate and report their liability.

   If these plans are provided for through the Law Enforcement Officers Fire Fighters Plan 1 or Public Employees Benefit Board, entities should use the actuarial tools created by the Actuary's Office. These tools will be available at www.osa.leg.wa.gov in early 2008. For other plans, entities will need to prepare their own calculations. All sources for assumptions and calculations will need to be available for audit.

2. The alternative measurement method may be used in limited instances to determine materiality of a plan. Those plans are:

   a. Plans with fewer than 100 members, regardless of the benefits the entity pays for.
   b. Plans that cover more than 100 members if the entity pays only for retiree medical coverage through an implicit rate subsidy.
   c. Plans with more than 100 members that use actuarial tools designed by the Actuary's Office may use the tool to determine materiality.

If one of the plans described above is determined to be immaterial, it will not have to be reported and an actuarial study will not have to be done.

Entities with plans that cover more than 100 members that pay for more than “an implicit rate subsidy” for retiree medical care are considered large complex plans. The Auditor’s Office will not accept “in-house alternative method calculations” for determining materiality for such plans. The Office will accept only materiality calculations that have been prepared by a certified or qualified actuary.

If the alternative valuation method is used, our office will audit it. Entities that exercise one of these options must fully document their assumptions, process and calculations used and make those documents available for examination.

Attached is a document further discussing implicit rate subsidy and use of the alternative valuation method for determining materiality.

If you have any questions, please call Phillip Parks, Assistant Audit Manager, Local Government Support at (360) 725-5595.

Sincerely,

Chuck Pfeil, CPA
Director of State and Local Audits

CP:PP:lt
Attachment

Implicit Rate Subsidy
and
Use of the Alternative Valuation Method to Determine Materiality

Implicit rate subsidy

"Implicit Rate Subsidy" is one of the more controversial aspects of Other Post Employment Benefits liability under GASB 45. Implicit rate subsidy is present if retirees are included in the public entity's health insurance plan for employees. For GASB 45 purposes, the "implicit rate subsidy" is the amount of subsidy or "cost" to the employer caused by the inclusion of retired employees in the health and dental insurance group maintained for current employees.

GASB's reasoning for requiring implicit rate subsidy to be included in the calculation of plan liability is based on following:

The cost of health care increases with an individual’s age, so generally, the cost of health care is higher for retirees than for active employees. If an employer pays all or part of active employee medical costs and retirees pay the same premium rate as active employees, an employer subsidy is implicit. The subsidy occurs due to blending of claims experience for active and retired employees. The employer is paying a higher cost for active employees due to the inclusion of retirees. However, it should be noted if the retired employees are rated separately from active employees and the retirees pay the entire cost, no subsidy is present.

Implicit subsidies must be included in post employment health-care liability even if retirees pay 100 percent of the blended premium rate.

In Washington, local governments that have retirees participating in a Public Employees Benefit Board (PEBB) plan will have an OPEB liability due to the implicit rate subsidy.

Use of the alternative valuation method to determine materiality

Entities with a plan reporting on the GAAP basis will need to address this liability. However, they may not need to hire an actuary. One method available to some entities is the alternative valuation method in GASB 45 that can be used to determine a plan’s “materiality.” If a plan is determined to be immaterial, an entity is not required to reported it.

To ensure conclusions about a plan’s materiality are correct, the Auditor’s Office recommends entities discuss those conclusions with us prior to the audit. Materiality determinations can be complex and may affect multiple opinion units in some entities.

The "alternative valuation method" is a do-it-yourself actuarial calculation created for small public employers. The statement specifically allows employers with fewer than 100 combined employee and retirees to use this method to calculate and report plan liability in lieu of an actuarial study. Our Office will allow expanded use of the alternative measurement method for determining materiality if their OPEB plans meet this criteria:

- Fewer than 100 members.
- More than 100 members with only an implicit rate subsidy.
- The State Actuary's Office has prepared a specific actuarial tool for calculation.

If an entity uses the alternative measurement method to show a plan is immaterial, the calculations and all assumptions must be available for audit. If a plan of 100 members or more is determined to be material, an actuarial study will be required to comply with GASB 45 requirements.

The do-it-yourself method is not an option for determining materiality for complex plans with more than 100 members. A complex plan would be present when an entity funds more than an implicit rate subsidy. Exclusion of complex plans is due to the variation in the types of benefits funded and the significant increase in actuarial assumptions that are required in calculations. This position is based on advice from the Actuary's Office and GASB. Large complex plans require the expertise of an actuary to accurately determine their liability.

It is important that entities use accepted actuarial assumptions and methodology when preparing an in-house alternative valuation method. Entities also need to assure their assumptions and calculations are "reasonable". Auditors will be reviewing the assumptions and calculations to assure they pass the reasonableness test. If the alternative method calculations are used for Law Enforcement Officers Fire Fighters Plan 1 or Public Employees Benefit Board plans we recommend local governments use the actuarial tools developed for these plans.

If a local government uses the alternative valuation method and determines that its plan liability is immaterial, it will not need to hire an actuary. However, we recommend entities continue to monitor their plans and related liabilities. In future years the liability may become material or plan terms or conditions may change and an external actuarial valuation may become necessary.