STATE OF TENNESSEE

DEPARTMENT OF FINANCE AND ADMINISTRATION

DIVISION OF ACCOUNTS

21st Floor William R. Snodgrass Building

NASHVILLE, TENNESSEE 37243-0298

February 19, 2008

To: Local Government Agencies Participating in the State-Administered Health Insurance Plans

PLEASE SHARE WITH YOUR FINANCIAL STATEMENT PREPARER

<u>New accounting standards that affect you</u>

The purpose of this correspondence is to provide you with information regarding the accounting and reporting of the financial liability of providing health insurance to your pre- and post-65 retirees through the state-administered plans. The Governmental Accounting Standards Board (GASB), the authority for state and local government accounting and financial reporting, has issued two new accounting standards that impact the state-administered health insurance plans. Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

The four health insurance plans administered by the state—State Employee Group, Teacher Group, Local Government Group, and Medicare Supplement (post age 65 retirees)—are <u>funded on a pay-as-you-go basis</u>. This means claims payments are estimated and premiums are budgeted to cover plan expenses each year.

Those new standards require that other postemployment benefits (OPEB)—of which retiree health insurance is one kind—be treated similarly to the way governments account and report pensions.

Pension benefits <u>are pre-funded</u> by governments based on actuarial valuations that calculate the amounts that need to be paid annually into the plans to ensure that funds are available to pay employees when they retire (i.e., pension payments to retirees are not budgeted each year when paid). Pension benefits are accounted for in irrevocable trust funds—assets of those trusts belong to retirees.

To treat OPEB like pensions, the standards require an actuarial determination of the amount that should be funded each year—the annual required contribution (ARC). Every government must decide whether or not to fund the ARC. Currently the state will continue to fund the OPEB on a pay-as-you-go basis. If the ARC is not funded, an OPEB liability has to be reported in the government-wide financial statements (full-accrual statements). In addition, lengthy disclosures of the funding status of the employer's liability are required. The standards require actuarial valuations every two years. The OPEB liability that is reported in the financial statements is initially calculated as the difference between the actuarially determined ARC and the amount of the premiums paid by the employer. Each year interest is added to the OPEB liability if the ARC is not fully funded and it continues to grow.

Pre-age 65 retirees enjoy the same insurance benefits that active employees do in the three main plans. The retired employees' share of the premiums are typically based on years of service, however, the base premium is the same as active employees base premium. When active and retired employees are commingled in the same plan at the same base premium (as they are in the state plans), there is an implicit rate subsidy. This implicit rate subsidy occurs because "typically" health claims for older employees are higher than those of younger employees and if the two groups were separated the premiums for retirees would be higher than those of active employees. GASB requires these employers to report a liability for the subsidy regardless of whether they contribute to retiree's premiums or not.

Unlike the three main health plans that cover active employees and pre-age 65 retirees, the Medicare Supplement Plan is not subject to the implicit rate subsidy and employer participants who do not contribute to their post-65 retiree's premiums will not have a liability.

How do we derive the liability amounts?

The state has contracted with an actuary to provide the necessary accounting and financial reporting information for each employer in its plans. Since the state plans are pay-as-you-go, the liability must be reported at the employer rather than the plan level. Those employers that provide a subsidy or a contribution to their retiree's healthcare benefits will have a liability for the implicit and explicit subsidies. Explicit rate subsidies are contributions to retiree's premiums. Employers who do not provide a subsidy or a contribution to their retiree's healthcare benefits will have a liability for the implicit rate subsidy only.

The state will provide full accounting and financial reporting information to Local Government employers who subsidize their retiree's premium. However, the employers who do not subsidize but are required to report an implicit rate subsidy liability and disclosure (for age-adjusted premiums) will be provided an amount that can be applied to the number of retirees in the plan (e.g., an amount representing the implicit rate subsidy per person).

The state expects to receive the actuarial report on April 15 and will provide the appropriate information to qualified plan employer participants shortly thereafter. The state is required to implement GASB Statement No. 45 for its fiscal year June 30, 2008 financial statements. Although the implementation date is delayed by one or two years for smaller governments, the actuarial information is to be used for the reporting period June 30, 2008 and it may be advisable for you to early implement. Otherwise, the liability you reflect in 2010 will have additional interest accumulated along with a factor for the unfunded ARC. Since actuarial evaluations are required biennially, our next actuarial report will be due in fiscal year 2010.

Last year the Division of Benefits Administration (formerly Division of Insurance) sent a survey to all employer participants in the teacher and local government plans. Based on your survey answers we have determined which employers subsidize their retirees' health insurance premiums and, therefore, will receive the full accounting and financial reporting actuarial data.

If you have any questions, please email them to Department of Finance & Administration, Division of Accounts, Financial Oversight Manager, Dianne McKay, at dianne.mckay@state.tn.us including your contact information (phone and email address) and you will receive a response. Please do not phone in questions.

Sincerely,

Jan I. Sylvis
Chief of Accounts