

- SUBJECT:** Accounting standard requirements for the state and political subdivisions
- COMMITTEE:** Pensions and Investments — committee substitute recommended
- VOTE:** 7 ayes — Truitt, Villarreal, McClendon, Burnam, Keffer, Macias, Rodriguez
0 nays
- WITNESSES:** For — April Bacon, Texas Association of County Auditors; Donald Lee, Texas Conference of Urban Counties; Timothy Lee, Texas Retired Teachers Association; Susan A. Spataro, Travis County Auditor; Brett Spicer, Travis County Sheriff’s Law Enforcement Association; Karen Sonleitner (*Registered, but did not testify*: Ted Melina Raab, Texas Federation of Teachers, Chuck Rice, Texas Association of County Auditors; Marsha Jones, Travis County Hospital District; Deborah Kastrin, El Paso County Commissioners Court; Julie Marks, Texas Association of Counties; Mark Mendez, Tarrant County; William Rogers, Texas State Employees Union; Greg Jacobs; Charles Vaughn, Diana Warner, Joe Marshall, Kimberly Walton)

Against — William Wallace Holder, GASB Board Member (*Registered, but did not testify*: Veronica DeLaFuente, Hidalgo County Commissioners Court; Richard Viktorin)

On — Charles S. Cox, city of Farmers Branch and Government Finance Officers Association of the U.S.; Lesli Ginn and David Mattox, Office of the Attorney General; Gwendolyn W. Santiago, Texas Association of School Business Officials; Robert Scott, Government Finance Officers of Texas; James A. Smith, Texas Society of CPAs; Suzy Whittenton, Texas Comptroller of Public Accounts, Michael H. Granoff.
- BACKGROUND:** In order to be considered actuarially sound, public pension systems must demonstrate that they have sufficient assets available to fund pensions for years in advance. However, for retiree health care and other benefits, most public pension systems, including the Employees Retirement System (ERS) and the Teacher Retirement System (TRS), operate on a “pay-as-you-go” basis, covering these expenses as they occur.

In June, 2004, the Governmental Accounting Standards Board (GASB), an independent nonprofit organization that sets financial accounting and reporting guidelines for state and local governments, issued GASB Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions," which establishes new accounting standards for state and local governments for reporting such non-pension costs as retiree medical care, prescription drugs, and life and dental insurance. These costs, referred to as "other postemployment benefits" (OPEB), consist primarily of costs related to retiree health care.

The new standard requires public employers to switch their method of accounting for OPEB benefits from "pay-as-you-go" to the "accrual" method, in which the cost of providing the benefits is reported as an expense during the years that the employees perform services in exchange for the benefits.

GASB standards do not have the force of law but are "generally accepted accounting principles." Therefore, government auditors and financial institutions normally consider compliance with GASB standards as a benchmark for financial reporting. Under GASB 45, governments are not required to fund their OPEB obligations, only to measure and report them.

DIGEST:

CSHB 2365 would establish a legislative finding that financial accounting and reporting should accurately reflect government activities and that state and local governments cannot provide certain post-employment benefits that exceed existing statutory, constitutional, or other legal requirements limiting appropriations to two years or less.

State law would prevail over accounting standards. The bill would add a new chapter to the Government Code governing financial accounting and reporting for the state and its political subdivisions. The statutory accounting principles and reporting standards would apply to any entity that was reported as a component unit on the financial statement of the state or a political subdivision.

The system of accounting for and reporting the financial activities for these entities would have to be consistent with state financial laws, could not misrepresent the nature, scope, or duration of financial activities, and would prevail when other accounting bases conflict with state law.

The bill would specify that in Texas, a statutory modified accrual basis of accounting qualifies as a comprehensive basis of accounting that recognizes revenue when it is measurable and available to finance current expenditures and recognizes these expenditures when they are normally expected to be liquidated with current financial resources regardless of when they mature.

The state and its political subdivisions would be authorized to account for and report selected types of financial activities on this modified accrual basis for government-wide and fund-level internal and external financial reports. Compliance with statutory accounting principles would satisfy any other law that required accounting and reporting according to generally accepted accounting principles.

Other post-employment benefits. To the extent that generally accepted accounting principles required the accounting or reporting of OPEBs at the government-wide or fund level on any basis other than pay-as-you-go, the bill would authorize the state and its political subdivisions to account for or report those OPEBs under statutory accounting principles in the bill.

Required OPEB disclosures. The state or a political subdivision would have to disclose in its notes to the financial statement:

- OPEBs that it provides in its substantive plan, including the covered employee groups, eligibility requirements, and the amount contributed by the state and the member;
- the statutory, contractual or other authority under which these OPEBs are provided;
- the accounting, financing and funding policies that it follows;
- the amount of OPEB expenditures that it recognizes during the period, net of member contributions;
- the number of members currently eligible to receive OPEBs;
- any significant matters that affect the comparability of the disclosures with previous reports; and
- any additional information that would help explain the nature and cost of the state's commitment to providing OPEBs.

If OPEBs had been advance-funded on an actuarially determined basis, the state or political subdivision also would have to disclose:

- the actuarial cost method and significant actuarial assumptions used to determine funding requirements and the method used to value plan assets;
- the number of active plan members;
- the actuarially required contributions for the period;
- the actual contributions net of member contributions for the period;
- the amount of net assets available for OPEBs; and
- the actuarial accrued liability and unfunded actuarial accrued liability for OPEBs according to the actuarial cost method in use.

If the state did not intend for OPEBs to be guaranteed benefits in future years, it would have to present financial statements and schedules in a manner consistent with these requirements. If the OPEBs were intended to be a potential benefit in future years as funding was made available to the state, the state would have to disclose its intention in notes to its financial statements and add supplemental information that would have to disclose, for informational purposes only, the expense and liability that would exist if OPEBs had been guaranteed and earned by employees.

Political subdivisions could, for informational and planning purposes only, disclose the expense and liability that would exist if OPEBs had been guaranteed to members. This disclosure would have to include the actuarial methods and assumptions or other estimation methodology; the entity's net OPEB obligation; its funding status and funding progress; and that the disclosure was for informational purposes only and was not an obligation or other promise to provide benefits beyond those approved by its governing body.

Communication of state's obligations. No later than December 1, 2007, a state system would have to fully disclose to retirees and others who receive post-employment benefits that the system was not obligated to provide these benefits beyond existing statutory, constitutional or other legal requirements. These would include requirements that limit the duration for which benefits are legally obligated such as Texas Constitution, Art. 8, sec. 6, which limits appropriations to two years or less.

A state system, including ERS and TRS, would have to inform its members about the extent of the system's commitment regarding OPEBs, including whether OPEBs were limited by funding obligations or whether funding obligations extended through the member's life. This information

would have to be disclosed on the state system's web site. These requirements would be optional for other governmental entities and political subdivisions.

The comptroller would have to issue reporting requirements to provide guidance on how to comply with accounting principles under the bill and maintain a web site to help the state and its political subdivisions to implement provisions of the bill. The site would have to include information that made it a resource tool to consistently manage OPEBs to conform to statutory, constitutional, and other legal requirements.

OPEB trust fund. The comptroller could establish and administer an OPEB trust fund for state systems to aggregate OPEBs as considered appropriate by the comptroller and the governing bodies of contributing state systems. Contributions and investment income for each system would have to be reported separately.

Effective date. The bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect August 27, 2007 and would apply to financial reporting for fiscal 2007.

SUPPORTERS
SAY:

CSHB 2365 would make it clear in statute that when accounting standards conflict with state constitutional and statutory requirements, Texas law prevails. GASB 45 has put state, county — and, to some extent, municipal governments — in an untenable position. If they comply with GASB 45 by listing health insurance benefits for retirees as liabilities on their financial reports, they could violate the Texas Constitution and statutory requirements. If these governments comply with Texas law and do not list OPEBs as liabilities on financial reports, they could be accused of misrepresenting their financial obligations.

The Texas Constitution limits appropriations to two years or less. Under Texas law, state and county governments cannot create liabilities without simultaneously creating an adequate funding source. Further, Texas courts have long held that a sitting county commissioners court cannot commit its successors to future financial liabilities.

CSHB 2365 would resolve this conflict by establishing a statutory basis for accounting that would allow Texas governments to depart from GASB's generally accepted accounting principles when appropriate. The

bill would allow these governments to continue to report OPEBs according to the accounting methods already in place and would provide an accounting option for governmental units that could not produce an accurate financial statement under the GASB rule.

If a public employer does not have contractual obligations to pay retiree health care costs, the requirements of GASB 45 create financial obligations that do not yet exist. The decision to pay all or part of retiree health benefits are made year to year. Governments can and do cut back on these benefits. If an entity chose to cut back on benefits, it would have a liability on its books that would look like a deficit. An employer that has entered into a contract to provide these benefits, as part of a collective bargaining agreement for example, should be required to report these costs as liabilities.

Retiree health care costs are different from pension benefits and should not be treated in the same manner in financial accounting. While pension costs can be actuarially estimated over a 30-year period, it is almost impossible to make such a projection for health care costs because of volatility in the health care market and changing health care practices.

Having to project retiree health care costs for the next two or three decades could lead government to cut back on retiree health benefits, just as private employers did when this accounting rule was imposed on them in the mid-1990s. Most governments cannot afford to prefund retiree health care, and if they were required to list these costs as a future liability in financial reports, they could decide to reduce benefits instead.

The bill would provide transparency by requiring state systems to disclose financial information about OPEBs in notes to financial reports and communicate to their employees and retirees the extent of the OPEB obligation to which the state is committed. The state would have to either guarantee these benefits or explain to employees and retirees that these benefits were not guaranteed.

This information is sufficient for bond rating companies to evaluate the financial condition of state and local governments. As long as this information is presented in a complete and reliable way, bond ratings should not be affected if a government chooses an alternative accounting method.

OPPONENTS
SAY:

GASB 45 is needed to provide financial markets and taxpayers important information about the extent of future financial commitments to current employees and retirees for health insurance and other benefits. This information is needed to evaluate the overall financial health of the state system or political subdivision.

Ignoring GASB 45 could damage credit ratings for state and local governments and increase borrowing costs. Fitch Ratings, a bond rating company, already has indicated that it could review Texas' bond rating if the state opts out of GASB 45.

Taxpayers have the right to know the extent of the promises the state has made to its current employees and retirees regarding health care and other non-pension benefits. These employees depend on benefits that were promised to them as part of accepting employment, and states are unlikely to rescind these promises. By requiring governments to calculate these costs, GASB 45 gives taxpayers and governments a clear idea of what future costs they are assuming with these promises to current employees.

Social Security, Medicaid, and other providers of retiree benefits routinely project the long-term costs of their programs. Any long-term promise to pay should be accompanied by an attempt to estimate the value of that benefit.

GASB 45 is a carefully considered accounting rule that would bring greater transparency to financial markets. Ignoring this standard could undermine GASB's authority to objectively establish standards and ensure continuity in the accounting profession. If each state were allowed to establish its own accounting rules, the nation's accounting system would be far less reliable.

NOTES:

The committee substitute added new subchapters addressing accounting for OPEBs, communication of the state's obligation for benefits to employees, and disclosure of information on financial statements.

The companion bill, SB 1102 by Duncan, was reported favorably, as substituted, by the Senate State Affairs committee on April 24.