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Understanding Postretirement Benefit Accounting

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UNDERSTANDING POSTRETIREMENT BENEFIT ACCOUNTING

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The Honors Program
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of the Requirements for the Distinction "All College Honors"
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In the Department of Accounting

by
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UNDERSTANDING POSTRETIREMENT BENEFIT ACCOUNTING

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CONTENTS

INTRODUCTION.................................................. 4
CHAPTER 1: HISTORY OF RISING COSTS...................... 7
CHAPTER 2: FASB RESEARCH PROCESS....................... 23
CHAPTER 3: REQUIREMENTS OF FAS 106..................... 29
CHAPTER 4: RESPONSES TO FAS 106......................... 37
CHAPTER 5: FINANCIAL STATEMENT EFFECTS................. 64
CHAPTER 6: GATHERING INFORMATION....................... 72
CHAPTER 7: PLAN DESIGN CHANGES......................... 78
CHAPTER 8: FUNDING OPTIONS.............................. 90
CHAPTER 9: OVERALL REACTIONS TO FAS 106.............. 100
WORKS CITED.................................................. 105
INTRODUCTION

Accounting for postretirement benefits is one of the most important and controversial issues in financial reporting today. What began as a minor supplement to employee compensation a few decades ago has grown into a major liability for many companies today. The Financial Accounting Standards Board (FASB) began to address this issue in 1979. Finally, on December 19, 1990, the FASB unanimously approved Statement of Financial Accounting Standards No. 106 (FAS 106), Employers' Accounting for Postretirement Benefits Other Than Pensions. FAS 106 requires employers to switch from the usual "pay as you go" (cash) basis to an accrual basis of accounting. The immediate result will be much higher reported expenses and liabilities for most companies.

This thesis centers around the requirements of FAS 106. The first part (Ch. 1-2) will show what led the FASB to issue this statement. This will include a brief history of postretirement benefits, an explanation of how and why the costs of these benefits rose so dramatically, and the FASB's 11 years of research on these benefits. The second part (Ch. 3-4) will focus on FAS 106 itself. This will describe the actual requirements of the statement, responses to these requirements, and the FASB's defense of
its position. The third part (Ch. 5-8) will speculate on the implications of FAS 106. This will consider the immediate impact on financial statements and the stock market, as well as the long term responses by companies and the government. Chapter 9 will conclude the thesis by summarizing the overall response to FAS 106, including both criticisms of and compliments to the FASB.

This thesis will not deal with the Governmental Accounting Standards Board (GASB), and their simultaneous study of postemployment benefits. The governmental obligation to provide benefits is significant; a 1990 Employee Benefit Research Institute estimated the public sector's liability to be $111 billion (#104-110,111). Currently, governmental employers are required to provide several descriptions of their postemployment benefits, as stated in GASB Statement No. 12, Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers. This statement, released in 1990, is similar to FAS 81, Disclosure of Postretirement Health Care and Life Insurance Benefits, issued in 1984. Many governmental employers were failing to follow the requirements of FAS 81, which prompted the GASB to issue a statement of its own. For a copy of this statement, see the Journal of Accountancy, June 1991, pp. 165-170.

This thesis is written for readers with some
knowledge of accounting and/or business. It is the author's hope that this thesis will provide readers with an understanding of the background, requirements, and implications of postretirement benefit accounting under FAS 106.

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Many thanks to Professors Thomas Murray, Lucy Larson, and Betty Wolterman for their time and suggestions.

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CHAPTER 1:

HISTORY OF RISING COSTS

Postretirement benefits are any benefits provided by a company to its retirees. These benefits are often extended to the spouses, dependents, and survivors of retirees. Since pensions were studied separately by the FASB, the term "postretirement benefits" refers to postretirement benefits other than pensions. The term "postemployment benefits" applies to retirees as well as disabled and laid-off employees. After initially including all postemployment benefits in its research, the FASB limited its study to postretirement benefits. The Board may study lay-off and disability payments in the future. From the FASB's early research we get the most common acronym for postretirement benefits: OPEB (Other PostEmployment Benefits) (#94-10). This thesis will use the term "postretirement benefits".

Postretirement benefits can take many forms. A company may continue to provide some of the same benefits to its retirees as it provides to employees. Some companies provide their products or services at a reduced cost. Others help retirees through educational assistance or housing subsidies. Many employers offer life insurance. However, the most common postretirement benefit is health
care. The scope of health care includes, but is not 
limited to, medical coverage, dental coverage, eye care, 
prescription drugs, long-term care, and retiree disability 
coverage. Because retiree health coverage is the most 
common and most expensive benefit, the FASB focused its 
attention on this area. Therefore, this thesis will focus 
exclusively on retiree health care benefits, although it is 
important to remember that FAS 106 applies to all 
postretirement benefits.

Postretirement benefits have a fairly short 
history. A few of these benefits first appeared during 
World War II, when wages were frozen and unions demanded 
other fringe benefits instead (#61-58). Postretirement 
benefits eventually became commonplace after Congress 
created Medicare in 1965. Employers viewed these benefits 
as inexpensive promises which would cover the small amount 
of medical expenses that Medicare did not. Their goal was 
to create goodwill which would help retain current 
employees and attract future employees, making the company 
more competitive (#22-18). Compared to today, the medical 
costs of the late 1960's were very cheap, and there were 
relatively few retirees to incur these costs. Few 
employers had the foresight to see the dramatic increases 
in the number of retirees and medical costs during the next 
two decades. So they made open-ended promises to cover all 
or a percentage of retirees' health costs.
To illustrate the future problems of making open-ended promises of postretirement benefits, the FASB invented the "Fred" scenario. Assume Fred, covered by his company's retiree health plan, retires at age 60. If he has a reasonable life expectancy of 78, that is 18 years of health benefits his company must provide. But the obligation doesn't stop there. Assume the company's plan is extended to spouses and dependents, as most plans are. Suppose Fred finds a 30-year-old wife who can expect to live to be 80. When Fred Jr. is born, the plan must be extended to him until he reaches 21. In all, there is a total of 89 years of benefits that must be provided by Fred's company (#61-58)! Granted, this is an extreme example, but it illustrates the huge obligations of many health plans. Companies are now realizing they promised more than they can deliver.

Today, most employers offer some form of postretirement benefit plan. In 1988, 95% of companies with over 5000 employees provided postretirement healthcare benefits (#53-21). Over 86% employers with over 1000 employees provided these benefits, while about 62% of companies with under 1000 employees had a retiree plan (#5-22). About 50% of companies with over 100 workers (#49-9) and at least 42% of companies with under 50 employees provided postretirement benefits (#5-22). Of all companies providing postretirement health benefits, 50% do not charge
retirees, and 80% extend coverage to spouses (#53-21). In 1988, at a cost of $9 billion to employers, 7 million retirees and spouses were covered by postretirement health benefits, with spouse coverage accounting for 52% of the cost (#7-18). For an extensive summary of postretirement benefit plans, see #60-101.

The cost of providing postretirement benefits has increased dramatically over the last 20 years. There are three major reasons for this increase in cost to companies:

1) Increasing percentage of retirees
2) Medical inflation
3) Medicare cutbacks

The higher portion of retirees in the population results in more medical utilization that companies must cover. Medical inflation has risen faster than the general inflation rate, making medical costs relatively more expensive today than in the past. The decreasing portion of costs covered by Medicare represents a shifting of health care responsibilities from the public to the private sector. The result of the combination of these three reasons is higher costs to companies that provide postretirement benefits.

The first major reason for the rapid increase in the cost of providing postretirement benefits is the rising
portion of retirees in the population. The number of retired workers is rapidly approaching the number of active employees. In 1967, the overall ratio of active employees to retirees was about 15:1 (#67-2). In 1974, this ratio had dropped slightly to 12:1, and by 1989 it had fallen to 3:1, according to the Washington Business Group on Health. This group also predicts that the active to retired employee ratio will continue to fall to 2:1 by the year 2000 (#91-55). The hardest hit have been the large labor intensive companies. Bethlehem Steel went from 70,000 active and 54,000 retired employees in 1982 to 37,500 active and 70,000 retired in 1987 (#75-98). In 1989, Chrysler's active to retiree ratio was 1:4 (#36-70)!

Companies are providing more benefits to an increasing number of retirees with a smaller portion of active employees to generate the necessary income.

There are two important reasons why the percentage of retirees in the population has risen so much:

1) Longer life expectancy
2) More early retirement

The first reason is quite obvious; Americans are living longer today. In the past 20 years, average life expectancy has increased by about one year every five years. With each additional year of life expectancy, the obligation for postretirement benefits is increased approximately 6% (#10-30). A 65-year-old man today can
expect to live to 80, while a woman of 65 can expect to reach 85 (#45-34). The National Institute on Aging and the University of Southern California predict that life expectancy for men and women will be 85.9 years and 91.5 years respectively by the year 2040 (#23-81).

The result of longer lifespans is a greater percentage of elderly in the population. During the last 30 years, the number of Americans over 65 has increased 130%, and this trend will continue into the future (#60-106). The number of senior citizens will increase by 63% by the year 2020 (#99-30). In 1989, 12% of the U.S. population was 65 or older (#91-55). This figure will rise to 15% by 1995 (#60-106), and 18% by 2020, which is comparable to Florida's population today (#61-58). The Census Bureau predicts that 20% of the population will be at least age 65 by the year 2030 (#91-55). The number of citizens 65 or older has increased dramatically (see graph).
The second reason for the larger number of retirees today is that more companies are encouraging early retirement (before age 65). In order to make room for younger, more efficient employees, many companies encourage the older employees to leave through a variety of incentives. In 1984, only 7% of companies offered early retirement incentives, but by 1986 this figure had risen to 23%, according to a Charles D. Spencer & Associates Inc. survey. A Wyatt Company survey found that the number of top 50 industrial employers offering early retirement windows went from 6 in 1985 to 16 in 1986 (#60-104). As a result of these incentives, more employees are retiring before age 65. According to Spencer & Associates, early
retirements as a percentage of all retirements went from 62% in 1978 to 70% in 1979 to 80% in 1983 to 84% in 1986 (#60-108). The average retirement age in 1986 was under 62 (#45-34). Companies must now deal with a larger number of early retirees. About 1/3 of all retirees receiving postretirement benefits are under 65 (#45-34). In 1987, around half of AT&T's 97,500 retirees and survivors were under 65 (#75-98).

As a result of longer living and more early retirements, the total number of retirees has increased almost linearly (see graph).

The increasing number of early retirees increases the cost of providing postretirement benefits. One obvious
reason is that it creates more recipients with a longer remaining life span. Medical expenses for senior citizens are nearly three times as great as expenses for the rest of the population, according to the Census Bureau (#91-55). But the most important reason for the higher cost is that retirees receive no Medicare benefits until they reach 65. For this reason, many early retirees will attempt to receive as much medical care from their former company as possible before Medicare kicks in. Also, many employees are forced to retire early because of sickness, making coverage for them even more costly (#61-66). Hence, companies must pay over twice as much medical cost for pre-65 retirees than for post-65 retirees. A 1990 Hewitt Associates survey found that the median annual cost of providing postretirement benefits was $2246 for a pre-65 retiree compared with $1033 for a post-65 retiree (#81-15). The cost of medical benefits for early retirees is increasing faster than the cost for retirees 65 and older. An A. Foster Higgins study found that between 1986 and 1988, postretirement benefit costs rose 18.6% for early retirees and only 9.6% for post-65 retirees (#66-13).

The second major reason for the rapid increase in the cost of providing postretirement benefits is that medical inflation has outpaced the overall inflation rate. This acceleration has been caused by increasing research
and development costs for new technology, rising malpractice settlements and fees, and new catastrophic cases like the AIDS crisis (#100-26). Since 1965, health care costs have grown at triple the rate of other goods and services, and these costs for the elderly have grown twice as fast as the cost for the rest of the population (#67-2). During the 1980's, health care costs rose at a 10.5% annual rate (#61-58). Each year since 1965, the medical care component of the Consumer Price Index (CPI) has increased at an average of two percentage points above the other CPI component increases (#5-24). According to the Bureau of Labor Statistics, from 1965 to 1975, overall prices rose 5.5% annually, while medical care prices increased 6.5%. From 1975 to 1987, these annual increases were 7.2% and 9.1% respectively (#4-6).

The result of rising medical inflation plus increased utilization has been an increasing percentage of Gross National Product (GNP) being spent on health care each year (see graph).
In terms of actual dollars, Americans spent $38 billion on health care in 1965 (#61-61). In 1990, this figure had risen to over $600 billion, not adjusted for inflation (#100-26). The National Study for Policy Analysis predicts that by the year 2000, 69% of the U.S. taxable payroll will be spent for health care and social security (#53-21).

The third main reason for the increase in the cost of providing postretirement benefits is that Congress has made cutbacks in Medicare in recent years. In 1984, almost half of the health care costs for the elderly were picked up by the government (#41-40). But the Deficit Reduction Act of 1984 (DEFRA) cut $13 billion in federal spending, mainly through reductions in Medicare and
Medicaid health programs for the elderly (#21-59). In 1986, the Medicare deductible rose 30% from $400 to $520 (#80-24). It appeared that Congress was reversing the trend of decreasing public health care spending after the passage of the Medicare Catastrophic Coverage Act of 1988 (MCCA). This Act would have made Medicare pay for 75% of hospital costs, greatly reducing employers' postretirement benefit costs (#31-81). The MCCA could have lowered companies' health costs by 20% to 25% and reduced liabilities 10% to 15%, according to Richard Ostuw, vice-president and senior group actuary at Towers, Perrin, Forster & Crosby (TPF&C) (#84-56). However, this Act was promptly repealed in 1989. According to Arthur Andersen & Co., if Medicare cuts its payments by 5%, companies' health care costs for retirees could increase by 15% (#74-53). The actions of Congress in the last decade have thus reflected an intention to shift more of the burden of health care coverage to employers.

Postretirement benefit plan costs are rapidly increasing. Due to the greater portion of retirees in the population and cutbacks in Medicare, businesses are paying a larger share of the total U.S. health bill. Companies paid only 18% of total medical costs in 1965. This figure rose to 28% by 1988 (#61-61). Between 1983 and 1986, Commonwealth Edison's annual postretirement benefit costs
jumped from $16.9 million to $33 million (#60-102). General Motors Corporation paid $1.1 billion in cash for retiree health costs in 1988 (#108-70), up from $820 million (23% of net income) in 1987 (#76-94). According to a Foster Higgins survey, the average company's annual health care cost for retirees and dependents jumped 20.2% during 1989 (#104-25,26) to $2083 per retiree (#30-21), resulting in $9 billion of total retiree medical costs (#7-18). Richard Ostuw predicted that companies' retiree medical costs will triple between 1987 and 2007 (#75-98). Businesses are spending an increasing portion of operating profits on employee and retiree health care (see graph).

Health Benefit Spending as % of Operating Profits

<table>
<thead>
<tr>
<th>Year</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>10</td>
</tr>
<tr>
<td>'70</td>
<td>20</td>
</tr>
<tr>
<td>'75</td>
<td>30</td>
</tr>
<tr>
<td>'80</td>
<td>40</td>
</tr>
<tr>
<td>'85</td>
<td>50</td>
</tr>
<tr>
<td>'90</td>
<td></td>
</tr>
</tbody>
</table>

(#61-61, #100-26)

The predictions of increasing future retiree levels and medical costs create a huge obligation for
businesses to provide postretirement benefits in the future. As this amount is dependent on many variables, estimating this liability can be very difficult. Speculation on this liability increased in the 1980's, and many estimates were made. In 1986, The House Select Committee on Aging estimated that the aggregate liability for America's 500 largest employers alone was $2 trillion (#99-32). This was the largest and most famous estimate, but most figures ranged between $100 billion and $500 billion. For example, the Employee Benefit Research Institute (EBRI) estimated the 1990 total unfunded private sector liability to be $169 billion (#105-110,111). In 1990, most major corporations cited liabilities ranging from $50 million to over $2 billion (#22-20). Chrysler Corp. has an estimated $3 billion liability (#36-70).

Liability estimates vary depending on how much future employee service is considered. In 1986, the EBRI estimated the liability for current retirees to be only $85 billion (#60-100). However, this estimate rises to $98 billion if current employees over 40 are also taken into consideration (#13-6). Some projections only considered the Accumulated Postretirement Benefit Obligation (APBO), or what is owed for all past service. However, a more realistic estimate is the Expected Postretirement Benefit Obligation (EPBO), which considers future service as well as past service. A 1988 General Accounting Office (GAO)
estimate placed the liability for prior service at $227 billion. When future service by employees is considered, this figure jumps to $402 billion (#90-13). The APBO is much larger for mature companies with a high percentage of retirees. The APBO is 63% of the EPBO of a typical mature corporation, while this figure is only 44% for the average immature company (#17-34).

The postretirement benefit liability is a significant obligation woven into the fiber of corporate America. The GAO's $402 billion estimate is equal to more than 7% of total corporate value (#90-13). The famous $2 trillion dollar estimate is equivalent to 150% of the total assets of all Fortune 500 companies (#72-53). Labor intensive companies with a large number of retirees have the most significant obligations. Liability estimates for some steel company's range from 20% to over 100% of equity (#99-32).

This significant liability for postretirement benefits is currently not reported on the balance sheet. Although it may be hard to estimate and estimates may vary considerably, almost everyone will agree that this obligation is huge. The FASB felt that the omission of this liability from the balance sheet is misleading to financial statement users. In 1979, the Board began an 11 year project to change postretirement benefit accounting from a cash basis to an accrual basis. The FASB's project
manager, Diana Scott, once summarized the Board's position on the postretirement liability: "We don't know how big the obligation really is, but we do know there is a significant liability that's currently absent from most employers' financial statements" (#57-40).
CHAPTER 2:
FASB RESEARCH PROCESS

The Financial Accounting Standards Board (FASB) spent 11 years researching postretirement benefits before releasing FAS 106, Employers' Accounting for Postretirement Benefits Other Than Pensions. The study began in 1979, when the FASB began researching the accounting for pensions and other postemployment benefits (OPEB). Before releasing FAS 106 in December 1990, the FASB issued four major releases regarding postretirement benefits:

1) FAS 81 - footnote disclosure (1984)
2) FAS 87 - pension accounting (1985)

These four releases helped pave the way for the final statement on postretirement benefits (#67-2).

The FASB released FAS 81, Disclosure of Postretirement Health Care and Life Insurance Benefits, in 1984. As the FASB realized the enormous scope of studying all forms of retirement benefits, they chose to focus first on pension accounting in February 1984. For this reason, the Board issued FAS 81 as an interim statement on postretirement benefit accounting until study could resume.
Effective December 15, 1984, FAS 81 required several disclosures about companies' postretirement health benefits in footnotes to the financial statements. These disclosures included:

1) A description of the benefits provided and the employee groups covered
2) A description of the accounting and funding policies followed for those benefits
3) The cost of those benefits recognized for the period
4) The effect of significant matters affecting the comparability of the costs recognized for all periods presented (#82-24)

The required appearance of postretirement benefit costs and obligations in footnotes was a step in the right direction. However, FAS 81 was formed only as an interim statement until a final statement on postretirement benefits could be developed. The FASB believed that the proper place for these expenses and liabilities was on the statement of income and the balance sheet.

The FASB finished its study of pension accounting in December 1985, releasing FAS 87, Employers' Accounting for Pensions, and FAS 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits. FAS 87 became
effective December 15, 1987. These two statements, especially FAS 87, would serve as a model for FAS 106. As a result, accounting for postretirement benefits is similar to the pension accounting found in FAS 87. Yet there are many basic differences between pensions and postretirement benefits (see table).

<table>
<thead>
<tr>
<th>Pensions</th>
<th>Postretirement Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control:</td>
<td>definite formula</td>
</tr>
<tr>
<td>Measurement:</td>
<td>reliable</td>
</tr>
<tr>
<td>Amount:</td>
<td>defined dollar</td>
</tr>
<tr>
<td>Payments:</td>
<td>monthly</td>
</tr>
<tr>
<td>Regulation:</td>
<td>ERISA</td>
</tr>
<tr>
<td>Prefunding:</td>
<td>common</td>
</tr>
<tr>
<td></td>
<td>outside factors</td>
</tr>
<tr>
<td></td>
<td>difficult trend rate</td>
</tr>
<tr>
<td></td>
<td>uncapped</td>
</tr>
<tr>
<td></td>
<td>as used</td>
</tr>
<tr>
<td></td>
<td>none</td>
</tr>
<tr>
<td></td>
<td>uncommon</td>
</tr>
<tr>
<td></td>
<td>(#99-33, #44-71)</td>
</tr>
</tbody>
</table>

Also, early retirement generally decreases pension expense while increasing postretirement benefit expense. There can be no retiree contributions for pensions, but retirees may have to contribute to postretirement benefits. Finally, pension payments are taxable to retirees when received, while the receipt of postretirement benefits is not taxable to retirees (#68-26).

In April 1987, the FASB issued Technical Bulletin 87-1, Accounting for a Change in Method of Accounting for
Certain Postretirement Benefits. As the FASB returned to its study of postretirement benefits, it released the Technical Bulletin to prepare companies for the coming accounting changes. It encouraged employers to begin accruing their postretirement benefit obligations. The Bulletin would permit those companies changing from a cash to accrual basis to recognize the effect of this change either in the period of the change or over future periods through amortization. It required participating companies to disclose the nature of the accounting change, why it was made, and the effect of the change on income before extraordinary items, net income, and related per-share amounts (#27-62). Like FAS 81, the Technical Bulletin was designed as an interim statement which would eventually be replaced by the final statement.

In 1988, some companies followed the Technical Bulletin's directions and recognized their postretirement benefit liabilities in a one period charge to earnings (see list).

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corning</td>
<td>$ 84 million</td>
</tr>
<tr>
<td>IBM</td>
<td>105</td>
</tr>
<tr>
<td>LTV</td>
<td>2260*</td>
</tr>
<tr>
<td>MERCK</td>
<td>32</td>
</tr>
<tr>
<td>Vulcan Materials</td>
<td>15*</td>
</tr>
</tbody>
</table>

*includes future retirees as well (#70-106)
However, most companies were hesitant to follow this advice. FASB chairman Dennis Beresford explained, "Many companies are waiting for us to finish our project because they don't like the idea of making a voluntary change now and possibly having to change again if our final guidelines are somewhat different from what they had done on a voluntary basis" (#101-144).

On February 14, 1989, the FASB issued its Exposure Draft (ED), Employers' Accounting for Postretirement Benefits Other Than Pensions, for public comment. The 476 paragraph Exposure Draft provided companies with a great deal of new information to contemplate. The FASB set August 14, 1989 as the deadline for comment letters. By October, 1989 they had received over 450 responses to the ED (#20-375). These comment letters came from a broad spectrum of the business community (see list).

electric and gas utility companies  49 letters
   oil and gas companies  31
   public accounting firms  24
   insurance companies  13
   actuarial firms  14
   trade associations  12
   metals companies  10

27
drug companies 10 letters
chemical companies 7
telecommunications companies 6
Big Three auto 3  (#108-1)

The Board then held public hearings in New York City on October 10 through 12 and in Washington, D.C. on November 2 and 3 (#28-17). At these hearings, some 63 organizations expressed their views to the FASB and staff. These corporate responses will be discussed more in Chapter 4.

In 1989, a field test of the Exposure Draft was applied to 26 companies. This study, called Retiree Health Benefits: Field Test of the FASB Proposal, was sponsored by the Financial Executive Research Foundation (FERF) and conducted by Coopers & Lybrand. After releasing the Exposure Draft, the FASB tentatively set November or December 1990 as the date for the release on the final statement on postretirement benefit accounting (#20-375). As it turns out, it was right on schedule.
CHAPTER 3:
REQUIREMENTS OF FAS 106

On December 19, 1990, the FASB unanimously approved FAS 106, Employers' Accounting for Postretirement Benefits Other Than Pensions. This final draft differed only slightly from the Exposure Draft. This chapter will summarize some of the major requirements of FAS 106. For a full copy of FAS 106, see the Journal of Accountancy August 1991, pp. 149-224.

The balance sheet liability for postretirement benefits is the Accumulated Postretirement Benefit Obligation (APBO) less the fair market value of any plan assets. The APBO represents the present value of future postretirement benefits attributed to employee service rendered before the balance sheet date. Plan assets are segregated and restricted investments intended to provide for postretirement benefits.

Net periodic postretirement benefit cost is the income statement expense which increases the postretirement benefit liability. The measurement of net periodic postretirement benefit cost involves six components:

1) Service cost
2) Interest cost
3) Return on plan assets
4) Amortization of prior service cost
5) Amortization of gains and losses
6) Amortization of transition liabilities

These components are quite similar to the components of pension cost found in FAS 87 for pension accounting. FAS 106 also requires several footnote disclosures about the company's postretirement benefits.

**Service Cost** is the portion of predicted future postretirement benefit payments attributed to employee service during the current period. This amount depends on six variables:

1) Substantive plan
2) Demographic assumptions
3) Medical cost trend rate
4) Rate of return on plan assets
5) Discount rate
6) Attribution method

The substantive plan, demographic assumptions, trend rate, and rate of return help predict the amount of postretirement benefit costs a company will incur in the future. When this amount is stated in terms of current dollars through the use of a discount rate, it is called the Expected Postretirement Benefit Obligation (EPBO). Finally, an attribution method must assign a portion of the EPBO as "service cost" to the current period.
The substantive plan, or actual plan, may differ somewhat from the written postretirement benefit plan. To define the substantive plan, the employer's cost sharing policy with employees must be determined. This policy is based on the employer's past practice regarding the postretirement benefit plan, or on the employer's communicated intentions of future plan changes to the employees. The substantive plan is necessary to help predict the future levels of benefits an employer will provide to retirees (paragraph 23).

Several demographic assumptions must also be made to help predict future costs. Demographic information such as predicted future retirement age and the probability of payment (based on turnover, dependency status, mortality, etc.) will require the assistance of actuaries. An assumption unique to postretirement benefits is the Medicare reimbursement rate (paragraph 30).

Another important assumption is the health care cost trend rate. This medical inflation rate accounts for increases in health care costs due to factors other than changes in demographics. This is a flexible trend rate to be re-calculated each year, and it will be different for each company. The trend rate should be based on health care inflation, changes in health care utilization or delivery patterns, technological advances, and changes in the health status of plan participants (paragraph 39).
A final assumption is the expected rate of return on plan assets. This cash inflow will decrease future postretirement benefit costs. The expected long-term rate of return on plan assets should be based on current returns and the expected rates of return to be available for re-investment with income tax expense taken into account (paragraph 32). The preceding assumptions, when applied to the substantive plan, determine the amount of postretirement benefits expected to be paid in the future.

The next step is to state the expected future benefit payments in terms of current dollars using a discount rate. This present value amount is called the Expected Postretirement Benefit Obligation (EPBO). Used to reflect the time value of money, discount rates must be based on the return on high-quality fixed-income investments currently available whose cash flows match the timing and amount of benefit payment (paragraph 31).

The final part of service cost requires allocating a portion of the EPBO to the current period by using an attribution method. This will reflect the amount of future benefits deemed to be earned by employees during the fiscal year. The total attribution period is the number of years during which an employee earns all his or her postretirement benefits. The FASB determined this period to begin with the date of hire and end with the date of full eligibility to receive the benefits. An equal
amount of the EPBO is attributed to each year of service during this period as "service cost" (paragraph 43).

The interest cost component of the net postretirement benefit cost recognized in a period is the increase in the Accumulated Postretirement Benefit Obligation (APBO) due to the passage of time. To recognize the time value of money, the interest cost must be accrued using rates equal to the assumed discount rates (paragraph 48).

The actual return on plan assets is determined by subtracting the fair market value (FMV) of the assets at the beginning of the period from the FMV at the end of the period, adjusting for contributions to and benefit payments from these plan assets. If the entity is taxable, any tax expense or benefit must be reflected in the actual return. A positive return on plan assets will reduce a company's net postretirement benefit cost (paragraph 49).

Prior service cost reflects employee service rendered in periods prior to the date of a plan initiation or amendment. A plan initiation or improvement should cause the employer to realize economic benefits in the future as the result of more satisfied employees. Therefore, this prior service cost cannot be written off
entirely in one period; rather, it must be matched with revenue in future periods through amortization. In most cases, the prior service cost should be amortized by assigning an equal amount to each remaining year of service to the full eligibility date of all plan participants. However, if virtually all participants have already reached full eligibility, prior service cost shall be amortized based on their remaining life expectancy. To avoid the complexity of calculating for each plan participant, a consistent method of amortization (e.g. straight-line) is acceptable. In some cases, accelerated amortization must be used. Finally, if a plan amendment reduces the APBO (i.e. through a cutback of benefits), any unrecognized prior service cost must be reduced first, then the unrecognized transition obligation should be reduced. Any excess must be amortized in a fashion similar to normal prior service cost (paragraphs 50-55).

Gains and losses are changes in the APBO or plan assets due to a) experience different from assumptions, or b) from changes in assumptions. These gains and losses must be amortized in future periods. Amortization must occur if the unrecognized net gain or loss exceeds 10% of the greater of the APBO or the market-related value of plan assets. The excess of this 10% "corridor" must be amortized in a fashion similar to prior service cost.
(paragraphs 56-60).

The final component of net periodic postretirement benefit cost is the amortization of transition assets and liabilities. The transition obligation or asset is the current difference between a) the APBO and b) the fair market value of plan assets plus recognized APBO or less recognized prepaid postretirement benefit cost. This amount can be immediately recognized, or it may be amortized over future periods. The liability or asset shall be amortized on a straight-line basis over the average remaining service period of active plan participants. However, if this period is less than 20 years, the employer may elect to use a 20-year period. Also, if virtually all the plan participants are inactive, the average remaining life expectancy must be used. An accelerated amortization method must be used if benefit payments made after the transition date exceed the postretirement benefit cost accrued after this date (paragraphs 110-112).

FAS 106 also requires the following disclosures in the footnotes to the financial statements:

1) a description of the substantive plan, including groups covered, types of benefits, funding policy, and types of plan assets
2) the amount of net periodic postretirement benefit cost, broken into its six main components, and the net total of other components

3) a schedule reconciling the funded status of the plan with amounts reported in the balance sheet

4) the assumed health care cost trend rate used in the present, and the ultimate trend rate expected

5) the discount rate used to measure the APBO and the expected long term rate of return on plan assets

6) The effect of a future one-percentage-point increase in the assumed health care cost trend rates on a) the service and interest cost components and b) the APBO

7) other relevant information (paragraph 74)

FAS 106 is effective for fiscal years beginning after December 15, 1992 for most companies. For plans outside the United States and for certain small, nonpublic employers, the effective date is delayed to December 15, 1994.
CHAPTER 4:
RESPONSES TO FAS 106

The response letters and the public hearings on the Exposure Draft offered many objections to the FASB's proposals. The Board backed down on some issues, compromised on others, but for the most part stood firm in its beliefs. The responses by businesses were important in helping the FASB create Statement 106 and defend its positions on postretirement benefit accounting. There were ten main areas of controversy:

1) Accrual accounting / Liability
2) Trend rate / Substantive plan
3) Discount rate
4) Attribution period
5) Transition obligation
6) Corridor
7) 1% disclosure
8) Vested postretirement benefit obligation
9) Minimum liability
10) Effective dates

The first issue the FASB had to address was whether or not accrual accounting was appropriate for
postretirement benefits. In 1982, the Board reached the tentative conclusion that postretirement benefits should be accrued (#44-70). The omission of the huge postretirement benefit liabilities from the balance sheet could be misleading to financial statement users. However, virtually all companies currently use a cash, or "pay-as-you-go" basis of accounting for these benefits. A 1988 Coopers & Lybrand survey found that about 95% of companies use the cash basis (#41-38).

Corporate reaction to the FASB's position on accrual accounting was mixed. About 60% of the Exposure Draft comment letters supported the FASB's view that the postretirement benefit obligation represents a liability that should be disclosed on the balance sheet. Another 9% believed this liability should only appear in a footnote. Finally, almost 15% argued that no liability exists for postretirement benefits. The two major objections to accruing the liability were:

1) The employer has the ability to cancel the obligation

2) The amount is unmeasureable (#63-21)

The first argument is defeated by the legal history of postretirement benefits and FASB Concepts Statement No. 6 (CON 6). The second argument is overcome by improving actuarial skills and a need for relevant information as stated in Concepts Statement No. 5 (CON 5).
Some respondents felt that since employers could cancel their obligation, postretirement benefits do not represent liabilities. The Financial Executives Institute (FEI) agreed that costs should be recognized under accrual accounting, but disagreed that the benefit obligation represents a liability. The FEI argued that the right to receive benefits is contingent on actual retirement and employers can modify these benefits. They even disagreed that postretirement benefits meet the definition of a liability found in CON 6. For these reasons, the FEI asked that the term "obligation" rather than "liability" be used (#87-19,20). Similarly, Shell Oil recommended the term "obligation" would be more meaningful (#102-17). Daniel Coulson, the accounting director of Ford Motor Co. declared, "we're not sure that accrual accounting is appropriate as it relates to existing employees, whose benefits are subject to change" (#50-6).

A look at the legal history of postretirement benefits reveals that employers do not always have the ability to discontinue their retiree benefit programs. In the 1980's, several companies tried unsuccessfully to decrease their health care costs by cutting back on their postretirement benefits. In 1984, Bethlehem Steel attempted to reduce promised health care benefits for 18,000 retirees. The retirees sued and won. The judge
determined that Bethlehem had not effectively reserved the right to alter these benefits for current retirees, since this language had been omitted from two summary documents (#61-66). A promise to provide postretirement benefits can be found in formal plans, employee booklets, newsletters, informal announcements, exit interviews, or collective bargaining agreements (#69-30). In order for employers to modify these promises, they must have explicitly stated the right to do so when the plan was designed. Otherwise postretirement benefit promises are enforceable contracts. As a result, more companies have begun to reserve the right to modify their postretirement benefits. In a 1989 General Accounting Office (GAO) survey, 27 of 29 employers had plan descriptions containing explicit language reserving their right to modify or terminate the plans (#25-12).

Bankruptcy cannot be used as a reason to terminate postretirement benefits. In 1987, LTV filed for Chapter 11 and attempted to cancel health benefits for 78,000 retired steel workers. However, the benefits were restored when the courts made it clear that even Chapter 11 does not provide a loophole for a company to escape its obligation to its retirees (#80-24). Senator Howard Metzenbaum (D-Ohio) even proposed an "LTV Bill" (Retirees Benefits Security Act of 1987) on the principle that "Retirees should not have to live in fear that their health
benefits can be unilaterally terminated" (#38-36).

The main reason why postretirement benefits should be reported as liabilities is found in FASB Concepts Statement No. 6 (CON 6). Paragraph 35 of this statement defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." A footnote describes the term "obligations" as "that which one is bound to do by contract, promise, moral responsibility, and so forth...." (#99-33). CON 6 goes beyond "legal obligations" and extends the liability definition to "moral obligations". Therefore, even if a company explicitly reserves the right to terminate its postretirement benefits, it may still have a moral obligation or social duty to provide the promised health care coverage to its retirees. Therefore, postretirement benefits should be recorded as liabilities even if employers do have the ability to cancel the obligation. The FASB also determined that postretirement benefits are a form of deferred compensation rather than a gratuity. In exchange for the employees' current services, the employer promises deferred benefits (#105-103). This satisfies CON 6's requirement that liabilities be the result of past events. Determining whether or not postretirement benefits are "probable future sacrifices"
is more difficult. That is why FAS 106 allows companies to use the substantive plan, which recognizes past practice or known future changes, when predicting future costs.

Most respondents (about 60%) agreed that the postretirement obligation represents a real accounting liability. The American Institute of Certified Public Accountants (AICPA) accounting standards committee unanimously agreed that the obligation meets the definition of a liability found in CON 6 (#87-19). The Financial Accounting Standards Committee of the American Accounting Association (AAA) also agreed with the FASB on this issue (#1-112).

Many respondents felt that postretirement benefits should not be recorded as liabilities because they cannot be reasonably estimated. Some argued that actuarial science could not provide accurate measures of postretirement benefit obligations. In 1987, a panel representing the American Academy of Actuaries warned the FASB that "the measurement of retiree medical benefit obligations is a young art striving to be a mature science.... It has only been in the last five years that the subject of retiree medical programs has received a lot of attention from the actuarial community" (#41-42). This panel declared that "Two actuaries valuing the same plan ... are likely to differ substantially [in their
projections]" (#42-46). In May 1988, the Interim Actuarial Standards Board (IASB) warned that "it would be misleading in most circumstances to present only a single actuarial present value" (#41-42). Even Diana Scott, the FASB's project manager, admitted that "there just aren't enough actuaries to do all the measurements" (#61-62).

Because of the measurement inaccuracies, many respondents felt that footnote disclosure of the obligation, as in FAS 81, would be more appropriate than balance sheet disclosure of the liability. Some believed that footnote disclosure would be intellectually more honest than pretending the balance sheet liability is accurate. Patricia McConnell, managing director at Bear, Stearns & Co., argued, "It is better to be correctly wrong, and have no number in the financial statement, than to be approximately correct [and mislead investors]" (#70-106). Some believed that financial statement users should be able to gather more relevant information if they are given a wide range of projections through a footnote. Currently, no reliable measure exists (#41-42). A. Herbert Nehrling Jr., the assistant treasurer of E.I. du Pont de Nemours & Co. said, "Instead of booking the liability, let the actuaries make a calculated judgment about a range of future numbers that would be disclosed in a footnote" (#32-61). Nehrling explained, "No one argues that accrual accounting is not conceptually appropriate, but we can't
tell you what health-care costs are going to be next year, much less 90 years from now" (#107-17). Lee J. Seidler, accounting analysis at Bear, Stearns & Co. agreed that the health care liability is too hard to predict, "So why slam it into the balance sheet?" (#76-94). Fred Zuckerman, treasurer for Chrysler Corporation, summed up the frustrations of many employers by exclaiming, "We would all be better off if we just had to write a few paragraphs in the annual report, rather than stick this right on the balance sheet" (#91-54).

The FASB held firm in its belief that postretirement benefit liabilities should appear on the balance sheet. Paragraph 63 of Concepts Statement No. 5 (CON 5) states that an item should be recognized if it meets four requirements: definitions, measurability, relevance, and reliability (paragraph 159). Postretirement benefit obligations meet the definition of a liability in CON 6. Paragraph 74 of CON 5 states, "relevance should be evaluated in the context of financial reporting: providing information that is useful in making rational investment, credit, and similar decisions." Postretirement benefit obligations meet this relevance requirement because of their importance to financial statement users. Paragraph 59 of CON 2 states that the reliability of a measurement depends on how well users can rely on it to represent economic conditions. This requirement is met because the
obligation is so relevant, users will be willing to give up some reliability in their calculation (paragraph 161). Diana Scott explained, "There's a trade-off between the reliability of the measurement and the relevancy of the financial information" (#57-40). The FASB also believed postretirement benefit liabilities to be measurable through the use of the substantive plan and the company's trend rate. Even the AAA argued that since companies are willing to offer postretirement benefits in the first place, they must be reasonably estimable (#1-112). Finally, the Board strongly believed that footnote disclosure is not an adequate substitution for recognition (paragraph 164). Diana Scott summarized the FASB's position:

"Unquestionably, measuring the expected benefit requires estimates of uncertain future events because the dollar amounts of those benefits are not fixed at the time they are earned. However, the board believes the company's best estimate of the cost of those benefits is better than implying, by a failure to accrue anything, that there is no obligation and no cost" (#28-17).

Many companies objected to the FASB's original proposed trend rate. The Exposure Draft did not allow companies to use the substantive plan to factor in any effects of probable future plan design changes. Over half the response letters addressed this issue, and under 5% of
these agreed with the FASB. Most felt that future changes should be taken into account. Others complained that it would be too expensive to gather the necessary information. For this reason, about 51% of these letters suggested using the general inflation rate or some other standard rate to improve comparability between companies (#63-23). The two suggestions can be summarized as:

1) Use a standard inflation rate
2) Allow substantive plan considerations

The FASB gave in on the second, but not on the first suggestion.

Many companies suggested different rates to use. Some supported the use of a general inflation rate because the current trend in rising health care costs cannot continue indefinitely (#59-16). A variation on this would be to permit only trend rate assumptions that result in health care costs reaching between 25% to 30% of GNP in 30 to 50 years (#41-42). The FEI proposed that the general inflation rate be used to determine long-term medical cost trends. The AICPA called for a measurement which excludes changes in healthcare usage, delivery patterns, and technological advances. Price Waterhouse suggested that companies be given the option to use the medical care component of the Consumer Price Index (#87-19,20). A few even proposed using current costs for less confusion and more comparability (#19-91).
Some respondents objected to the many assumptions involved in computing the trend rate. The Management Accounting Practices (MAP) Committee said the FASB's trend rate is based on too many variables that are critically dependent on future events. MAP suggested using more reliable assumptions, since even small differences in estimates can result in huge changes in expense (#9-56) (see table).

<table>
<thead>
<tr>
<th>% Change in First Year Expense From Best Estimate</th>
<th>Highly Mature</th>
<th>Immature</th>
</tr>
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<tbody>
<tr>
<td>Optimistic Assumptions</td>
<td>-5% to -9%</td>
<td>-9% to -13%</td>
</tr>
<tr>
<td>Pessimistic Assumptions</td>
<td>7% to 12%</td>
<td>12% to 16%</td>
</tr>
<tr>
<td>1% Decrease</td>
<td>-9% to -14%</td>
<td>-14% to -22%</td>
</tr>
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The FASB held fast to its trend rate based on each individual company's assumptions. The Board had reached this tentative conclusion in June 1987 (#13-6). They felt that financial statement users could better compare companies if employers used individual assessments (paragraph 182). Patricia McConnell of Bear Stearns agreed, saying, "The press has talked about the softness of the trend number. But analysts feel that if the trend rate is disclosed, it will enable them to better compare companies" (#62-58). The AAA also supported the FASB.
They believed using a general inflation rate would understate costs, because health costs are rising faster than inflation. They rejected the use of a medical inflation rate because it didn't take technological changes, a major component, into account. They felt that the medical component of the CPI was too general, not taking differences between plans and regions into account. The AAA admitted the health care cost trend rate would be difficult to estimate, but like Keynes, they "would rather be vaguely right than precisely wrong" (#1-113,114). A universal trend rate may not be appropriate for an individual company because postretirement benefit plans vary by location, community, age, and type of service (#4-5).

Many respondents saw the FASB's inconsistency in requiring assumptions of future demographics and health care costs, but not allowing assumptions of the substantive plan. Shell Oil called the FASB's proposal a "fundamentally uneven approach." Companies are forced to estimate future events over which they have no control, but are not allowed to factor in future changes over which they do have control and may even plan to implement (#102-15). James Kelly, comptroller at Phillips Petroleum Co. wrote, "The board would require companies to estimate the effects of health care inflation, changes in health care utilization or delivery patterns, technological advances
and changes in the health status of plan participants. Conversely, the board would not allow companies to take into account the effects of future changes to benefit plans or government health care cost-sharing programs. We believe this provision to be inconsistent" (#108-70).

Taking the substantive plan into account can make a huge difference in costs. For example, Shell Oil, a field test participant, has amended its retiree plan every year for the last ten years. The Exposure Draft, which ignored this past practice, overstated Shell's first year expense by 60% (#59-17). As a result of these complaints, the FASB agreed to allow the use of the substantive plan on April 11, 1990 (#43-46). Companies must be able to prove their substantive plans. FASB chairman Dennis R. Beresford explained, "In the absence of any evidence to the contrary, our assumption is that management intends to keep the promises that it has made, and that the plan will continue into the indefinite future" (#67-4).

Many respondents disagreed with the FASB's proposed discount rate. FAS 106 requires the use of a) the "settlement rate" (the rate on an instrument that could be used to settle the obligation) or b) the rate of return on high-quality fixed-income investments. This is consistent with pension accounting in FAS 87. Under 6% of all comment letters agreed with this approach. The two
major objections were:

1) No settlement instrument specifically designed to cover benefit costs exists in the financial market

2) The funds used to pay the obligation are generated internally, not by investments

(#63-23)

Several alternative discount rates were suggested. The most common alternative rate suggested was the company's cost of capital. The AAA recommended using some form of discount rate which would be more consistent with an employer's borrowing rate for unsecured debt. This is because, unlike pensions, postretirement benefits are generally not collateralized by high-quality investments (#1-114). Shell Oil objected to the FASB's proposal, saying the proposed rate is not precise for an obligation that extends out as much as 70 years. Shell suggested using an actuarially smoothed long term bond rate. Other options included internal cost of capital or return on equity rate, since the obligation will most likely be discharged from internal funds anyway (#102-16). Many criticized the expected volatility of the FASB's rate, as it is based on current market conditions (#95-43) (see table).
% Change in First Year Expense From Best Estimate

<table>
<thead>
<tr>
<th></th>
<th>Highly Mature</th>
<th>Immature</th>
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<tbody>
<tr>
<td>1% Increase</td>
<td>-2% to -10%</td>
<td>-9% to -18%</td>
</tr>
<tr>
<td>Company Specific Rate</td>
<td>-3% to -32%</td>
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(#2-35)

The FASB defended its view on the discount rate. Conceptually, the rate should be the same as the pension discount rate found in FAS 87 (paragraph 187). It rejected the indebtedness model because the obligation is not dependent on the level of plan assets (paragraph 190). The cost of capital method was rejected because there is no uniform method (paragraph 191). Finally, the normalized long-term rate was rejected because it would be no less volatile than the FASB's rate which is updated each year (paragraph 192). The field test showed companies would use a company specific rate higher than the general settlement rate. This would understate the obligation (#83-26).

One of the biggest controversies with the Exposure Draft involved the attribution period. The FASB determined that employees earn their postretirement benefits, like pensions, from the date of hire to the date of full eligibility to receive these benefits. Nearly 80% of the comment letters addressed this issue, and only 2% of these supported the FASB's position (#63-21). Most
respondents felt that the FASB should lengthen this attribution to the expected date of retirement for two reasons:

1) Would be a more realistic period
2) Would decrease initial expense

Companies used the first argument exclusively. However, the second reason was the driving force.

Most respondents argued that an attribution stretching to the retirement date would be a more realistic time frame for employees to earn benefits. Postretirement benefits "cliff-vest", meaning that an employee can only receive them after retirement. Therefore, using the expected retirement date may provide a better matching of revenues with expenses (#105-107,109). The MAP Committee declared that the attribution period should reflect the fact that benefits are actually earned over the total service period (#9-56). The AAA felt that the FASB is wrong in focusing on the legal form of the agreement rather than the substance of the understanding between the employer and the employee. The AAA believed the attribution period should recognize the intent of the benefits, which are compensation for all services before retirement (#1-113). Similarly, Shell Oil blamed the FASB for placing form over substance in its struggle for conceptual purity. Shell suggested that a full-service approach would provide more decision-useful information.
(#102-16). For these reasons, the AICPA, the FEI, and Price Waterhouse all called for a lengthening of the attribution period (#87-19,20).

Lengthening the attribution period to the retirement date would also decrease initial expense. With more years to allocate costs to, employers could expense a smaller amount each year than under the FASB's proposal (see table).

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<th></th>
<th>Highly Mature</th>
<th>Immature</th>
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<tbody>
<tr>
<td>First Year Expense</td>
<td>-1% to -8%</td>
<td>-5% to -21%</td>
</tr>
<tr>
<td>10-Year Cumulative</td>
<td>-1% to -10%</td>
<td>-7% to -18%</td>
</tr>
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(2-36)

With a higher percentage of active employees responsible for future costs, immature companies could greatly decrease their expense by stretching these costs to the future retirement dates of these employees.

Despite these arguments, the FASB kept the attribution period between the date of hire and the full eligibility date. This was a surprising decision. One expert declared there was a 75% chance the FASB would agree to lengthen the attribution period, especially since two Board members had dissented in the Exposure Draft (#42-51). However, the attribution period was sustained by a slim 4
to 3 final vote (#43-48). The FASB defended its position, saying the full eligibility date is both more understandable and more consistent with the accounting for other deferred compensation contracts under APB Opinion 12 (paragraph 223). Attribution beyond the date of full eligibility would incorrectly suggest that there is a difference between "fully vested" pension benefits and "fully eligible for" postretirement benefits. In both cases, the FASB reminded, an employee earns the right to receive benefits after retirement (paragraph 235). Also, for many companies, the difference in the results of the two attribution periods is minimal, according to the field test (paragraph 225).

Another controversial area of the FASB's proposal was how to account for the transition obligation. The FASB originally required employers to amortize the transition obligation (APBO before the effective date of the statement) over the average remaining service period of covered employees, with the option of electing a 15-year amortization period if the average remaining service period was less than 15 years. Most importantly, companies would not be permitted to expense the entire transition obligation immediately. This was the same approach taken for pensions in FAS 87. Of the letters that commented on this issue, under 2% agreed with the FASB. The two most
common suggestions were:

1) Extend amortization period

2) Allow one-time charge to earnings

Over 25% suggested amortizing the obligation over a 30 to 49-year period. Additionally, 93% argued that companies should have the options of treating the FASB's new rules as a change in accounting principle with a one-time charge to income, or as a prior-period adjustment with a one-time charge to retained earnings (#63-23).

Many respondents called for a longer transition period with more options. A. Herbert Nehrling of the ERISA Industry Committee called for a longer transition period, saying, "The transition obligation is a practical matter, rather than accounting theory. It requires practical rules" (#59-17). Price Waterhouse called for more flexibility by allowing immediate recognition. The FEI suggested immediate recognition as well as a 20-year, rather than 15-year, option (#87-20). The MAP committee also called for the option of taking a one-time charge or a 30-plus-year amortization period (#9-56). Ford Motor Co. suggested a 30 to 35-year period (#50-6). Du Pont proposed an immediate or 20-year option, as well as a grandfathering of current retirees on a cash basis (#48-23). Other suggestions included a mortgage-type amortization approach with an increasing amortization amount. These options could greatly reduce early expense
(see table).

<table>
<thead>
<tr>
<th>Percent Change in Expense From Best Estimate</th>
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<tbody>
<tr>
<td>Year of Adoption</td>
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<tr>
<td>30-Yr Amortization</td>
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<tr>
<td>Mortgage Type</td>
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<td>Grandfathering</td>
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Theoretically, companies should be allowed to take a one time charge to earnings. APB Opinion 20 concluded that "most changes in accounting should be recognized by including the cumulative effect...of changing to a new accounting principle in net income of the period of the change" (#42-50). Forced amortization understates liabilities throughout the transition. It also reports expenses of previous promises and activities while reporting current expenses (#105-109). The AAA called for the option of a one-time charge to income because the proposed accounting is a departure from current practice. A uniform phasing-in of the obligation will not create uniformity between companies, because some companies had already begun reporting this obligation after Technical Bulletin 87-1 (#1-115,116). Also, some argued that the accounting for postretirement benefit transition obligations should not parallel FAS 87 because the APBO is
so much larger for FAS 106 (#83-27). Finally, a "one-time-hit" of the liability on the financial statements would be desirable for some companies. Patricia McConnell of Bear, Stearns & Co. claimed, "It is preferable from the investors' perspective to get it behind you so that it doesn't affect earnings for the next 15 years" (#62-58).

The FASB decided to change its transition method requirements, allowing immediate recognition and increasing the optional amortization period to 20 years. Lengthening the transition period was an easy decision. A longer period would help to minimize disruption of current practice. Also, the field test indicated the average remaining service period of active plan participants was between 18 and 21 years, higher than previously anticipated (paragraph 253). As a result of these arguments, the Board agreed to lengthen the transition period by a 6 to 1 vote in the summer of 1990 (#12-3).

The immediate recognition allowance came as more of a surprise. One expert gave a 75% chance that the transition period would be lengthened, but only a 25% chance that the FASB would allow immediate recognition (#42-51). The FASB clarified that the transition obligation for postretirement benefits reflects the failure to accrue the obligation in earlier periods rather than the effects of changing from one accrual method of accounting to another (paragraph 247). Some Board members objected to
immediate recognition because it could result in premature recognition of unrecognized prior service cost and unrecognized net gains and losses included in the transition obligation (paragraph 257). Still, most members decided to allow immediate recognition. One Board member argued, "Employers have always been accounting for it wrong, so it should all be recognized immediately" (#54-14). Immediate recognition is permitted under certain constraints. The Board concluded that allowing immediate recognition at any time after the effective date of FAS 106 would result in too much variability in financial reporting for a long period of time (paragraph 260). Also, certain parts of the transition obligation must be excluded from immediate recognition because they would be better reflected in determining future period income (paragraph 261). Finally, the transition obligation must be a charge to income, not retained earnings (paragraph 264).

A less common objection involved the FASB's corridor of 10%, above which actuarial gains and losses must be amortized. This was another similarity to FAS 87. Price Waterhouse suggested widening this corridor to 20% (#87-20). Shell Oil believed the FASB lacked sufficient data to determine a correct corridor, since the field test did not deal with gains, losses, or the effects of plan amendments. Therefore, the Board should study these
issues before deciding on a corridor (#102-16). Some stated there will be greater volatility of postretirement benefit measurements than pension measurements, so a wider corridor is necessary (paragraph 299). Eventually, the FASB tested the effects of widening the corridor to 20%. The results showed this would have little effect on controlling the volatility of net cost. Therefore, the Board decided to leave the corridor at 10%, staying consistent with FAS 87 (paragraph 300).

A fairly common objection was to the footnote requirement to show the effects of a 1% change in the health care cost trend rate. Almost 60% of the response letters addressed this issue, and about 4% of these agreed with the FASB's approach. The two main objections were:

1) No sensitivity analysis is required for other assumptions, which are as important

2) The requirement may cast doubt on the reliability of the employer's trend rate assumption and, by implication, the reliability of the other assumptions as well (#63-23)

As we have seen, small changes in the trend rate can have a huge effect on costs. A Milliman & Robertson study showed that a 1% change in the trend rate would change the benefit cost amount by 10% to 40%, depending on the portion of the
covered group currently retired (#41-40).

However, the Board defended its position, saying the disclosure will assist users in comparing different companies and the extent to which future changes in assumptions and experience will affect cost (paragraph 354). Although no sensitivity disclosures are required for pension benefits, the FASB concluded that the information is more compelling for postretirement benefits, since financial statement users are less familiar with these measurements (paragraph 355).

There was much objection to the Exposure Draft requirement that the Wusted Postretirement Benefit Obligation (VPBO) be disclosed in the footnotes. The VPBO disclosure would require employers to provide information about their obligation to retirees and fully eligible employees if they retired immediately. Over 47% of the comment letters addressed this issue, and, of these, under 5% agreed with the FASB. Two major objections to the VPBO were:

1) Unlike pension benefits, postretirement benefits do not "vest" legally, so this term and disclosure would be misleading.

2) The VPBO assumption is that all eligible employees retire at the balance sheet date. This is not only unrealistic, it contradicts the going-concern assumption (#63-23).
The FASB decided to remove the VPBO disclosure from FAS 106. However, they added the more useful APBO information disclosure in the footnotes (paragraph 347).

The Exposure Draft also required the reporting of an additional minimum liability under certain circumstances. As in FAS 87, this requirement was designed to limit the extent to which delayed recognition of the transition obligation, plan amendments, and losses could result in the omission of liabilities. The minimum liability was defined as the unfunded APBO for retirees and other fully eligible plan participants. If this amount exceeded the APBO, the difference had to be reported as a liability on the balance sheet to assure representational faithfulness. It would have been effective on December 15, 1997, five years after the FAS 106 effective date (paragraph 303). The AAA supported the FASB's position, stating that this requirement would reinforce the conclusion that postretirement benefits represent real liabilities (#1-115). The AICPA opposed the minimum liability, but said if it is required, it should only apply to retirees (#87-19). Few believed the minimum liability requirement would be dropped. While two board members favored eliminating it, the other five members believed the five year delay of the effective date would take care of most practical problems (#42-51).
However, on April 11, 1990, the FASB decided to drop the minimum liability requirement. Some Board members saw an inconsistency between this proposal and the delayed recognition requirements. Others saw an inconsistency between the APBO applying to all plan participants, while the minimum liability would only apply to fully eligible participants; this could be confusing to financial statement users (#43-48). Also, the field test showed that the minimum liability provision would be inoperative for mature companies after 8 years, and after 10 years for immature companies (paragraph 305). Since the reporting requirement for the minimum liability would have been delayed five of these years, it would be a meaningless requirement.

Finally, many respondents to the Exposure Draft called for a delay of the effective dates. The ED set the effective date for December 15, 1991 for most companies, and December 15, 1993 for others. About 40% of all letters commented on the effective date. Nearly 90% called for a two to three year delay, so that companies could develop the necessary data-gathering capabilities (#63-23). The FASB moved the dates back one year to December 15, 1992 and December 15, 1994. FASB Chairman Dennis Beresford explained, "We received information that it would be hard to accumulate information and to train actuaries. It would
be fair to give companies one more year to do it in an orderly fashion" (#29-70).

The FASB changed very few requirements from the Exposure Draft. Immediate recognition of the transition obligation was allowed, and the 15-year amortization period was extended to 20 years. The VPBO disclosure as well as the minimum liability requirement were dropped. Finally, the FASB gave companies an extra year to prepare by moving the effective date from Dec. 15, 1991 to Dec. 15, 1992. Otherwise, the Exposure Draft and FAS 106 are virtually identical.
CHAPTER 5:  
FINANCIAL STATEMENT EFFECTS

FAS 106 will have a huge effect on most companies that offer postretirement benefits. Diana Scott explained that "the Board's final decisions probably will have a greater effect on financial statements than any other FASB pronouncement" (#89-56). Managers will begin to gather necessary information to make plan design changes and consider funding strategies to control the new expenses and liabilities.

FAS 106 will greatly increase the reported cost of providing postretirement benefits in a very short time. The GAO predicted that accrual accounting would increase the annual postretirement medical cost from $9 billion to $28 billion, an increase equal to 1/16 of aggregate 1988 corporate profits (#7-18). Many companies can expect to see their retiree medical cost increase as much as 500% (#33-17). For example, Bank of America's annual cost could go from $13 million to about $75 million (#104-30). Richard Ostuw of Towers, Perrin, Forster, & Crosby (TPF&C) predicted the recorded cost of retiree medical benefits would go from under $500 per worker to over $3000 for most large companies (#77-39). A Hewitt Associates survey determined that FAS 106 would increase expenses
considerably for the average company. Retiree medical expense would go from 2% of pre-tax profits under the cash basis to 7.5% under the accrual method. Similarly, these expenses would go from 1.1% to 6.25% of active payroll and 0.5% to 2% of equity. In fact, for over 40% of employers the new costs will be over 10% of pre-tax profits, and 20% of employers will experience accrued costs of over 30% of pre-tax profits (#30-21,22).

According to a National Association of Accountants (NAA) study, the increase in first year expense under FAS 106 would be relatively greater for immature companies, because they are paying less under the cash basis than mature companies are (see table).

<table>
<thead>
<tr>
<th>Ratio of Active Employees to Retirees</th>
<th>First Year Expense as Multiple of Cash Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mature:</td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>2 times</td>
</tr>
<tr>
<td>2</td>
<td>4</td>
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<tr>
<td>3</td>
<td>6</td>
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<td>5</td>
<td>7</td>
</tr>
<tr>
<td>Immature:</td>
<td></td>
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<td>6</td>
<td>8</td>
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<td>11</td>
<td>9</td>
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<td>19</td>
<td>18</td>
</tr>
<tr>
<td>25</td>
<td>13</td>
</tr>
</tbody>
</table>
| 331                                  | 43                                          | (#3-37)

65
Similarly, cost components under FAS 106 will vary depending on the maturity of a company, according to the Financial Executive Research Foundation (FERF) study (see table).

<table>
<thead>
<tr>
<th></th>
<th>Highly Mature</th>
<th>Mature</th>
<th>Immature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service Cost</td>
<td>4-16%</td>
<td>11-25%</td>
<td>25-52%</td>
</tr>
<tr>
<td>Interest Cost</td>
<td>49-65%</td>
<td>45-56%</td>
<td>34-46%</td>
</tr>
<tr>
<td>Transition Amortization</td>
<td>30-41%</td>
<td>26-37%</td>
<td>14-29%</td>
</tr>
</tbody>
</table>

As a result of the higher expense under FAS 106, accrual accounting is expected to reduce total U.S. corporate profits by over $200 billion (#58-51). The Employee Benefit Research Institute (EBRI) estimates an average reduction in earnings between 15% and 20% for Fortune 500 companies; this figure would be much higher in some industrial industries (#67-6). Richard Ostuw predicted that the top 100 industrial companies could experience a 25% reduction in profits (#28-17). General Motors Corp. could see its net income drop by over $1 billion (#14-48,49).

Many companies could have an even greater reduction to net income due to the requirements of FAS 96,
Accounting for Income Taxes. According to this statement, the excess of the accrued expense over the deductible medical payments would be a "temporary difference". Yet recognition of this difference as a deferred tax benefit, an asset on the financial statements, is limited to amounts that could be offset against deferred tax credits in the same future year or potentially carried back. Many companies would not be able to record a tax benefit to help offset the higher expense, thus directly reducing net income (#6-24). However, this requirement of FAS 96 is now in the process of being reversed by the FASB.

Eventually FAS 106 will help increase net income. From 1993 to 2015, companies' net incomes will generally be reduced. But after this period, income should rise as business "catches up" to accrual accounting (#74-53). The postretirement benefit expenses accrued for current workers today will apply toward their actual receipt of these benefits after their retirement in 20 years.

The recognition of a postretirement benefit liability on the balance sheet will greatly reduce the values of many companies. A TPF&C study estimated that the new accounting rules would reduce net worth an average of 11% (#40-4). Chrysler's book value could be reduced by 2/3 (#36-70). Chrysler vice chairman, Robert S. Miller Jr., speculated, "Putting the liability for all those future health care benefits on the balance sheet - and the total
amount, we think, equals or exceeds the current tangible net worth of the Big 3 auto companies - we may well have the entire industry end up with zero tangible net worth" (#50-3). Kidder Steel analyst Robert Hageman went even farther, declaring, "you're wiping out the asset base of most of corporate America" (#36-69). While these two predictions may be extreme, Diana Scott admits that "For some companies, the obligation to provide postretirement benefits may be their greatest single liability" (#89-56).

These financial statement effects of FAS 106 could harm some companies more than others. The large new balance sheet liability may cause some existing loan covenants to be violated, and the ability to obtain additional financing could be reduced or even eliminated (#71-48). Companies competing in the international market would also be adversely affected. U.S. companies would fare unfavorably with companies from countries that have a national health care program, or where employer-provided benefits are not customary (#99-32).

There is some disagreement on how these financial statement changes will affect the stock market. Many investors believe FAS 106 will have little or no impact on the market. Jeffrey Miller, an analyst at Duff & Phelps Inc., states, "It [FAS 106] will make people more aware of the magnitude, but I think the market is already aware of that anyhow" (#107-15). Similarly, both Moody's Investors
Service Inc. and Standard & Poor's Corp. (S&P) believe the statement will also have little effect on credit quality because the postretirement benefit liabilities have already been factored into company ratings (#93-3). Others believe the new statement will have little impact on the stock market because FAS 87 for pensions had almost no impact on stocks. Douglas A. Love, research director at BEA Associates Inc. declares, "Anyone who thinks it [FAS 106] will be a big issue in terms of stock prices either doesn't know how the market works or doesn't know history."

Companies will also begin to control costs by redesigning their postretirement benefit plans. Mr. Love continues, "The application of (medical) cost management will lower that cost, which will keep stock prices from taking a dive. By the time of the actual adoption date, most of this will be a non-issue" (#107-17). Patricia McConnell of Bear Stearns agrees, saying that managers will prepare for FAS 106, making it a "financial reporting yawn" by the effective date (#62-58).

However, most analysts are less optimistic. In 1989, Sherlock Company surveyed analysts who work for fund managers that represent about 20% of all U.S. capital. Over 75% of the respondents felt that the new statement would generally have a negative impact on stocks (#106-14). Many analysts disagree that postretirement benefit liabilities have always been taken into account. Most
unsophisticated investors could not have understood the scope of a company's obligation from the mere footnote required in FAS 81. Patricia McConnell admits, "The market hasn't gone to a cash flow-per-share measure of company performance. They're still looking at price/earnings ratios" (#62-58). Many experts refuse to equate FAS 106 with FAS 87, because the expenses and liabilities for postretirement benefits are much higher than those for pensions were. In 1984, Harold Dankner of Coopers & Lybrand speculated, "If the FASB decides to put a liability on the balance sheet for these post-employment benefits, it might be far bigger than the liability for pension costs" (#8-244). Many employers chose early compliance with the expense and disclosure requirements of FAS 87, which often led to a positive effect on income when the statement became effective. Also, FAS 87 did not significantly reduce the range of assumptions used in calculating pension expense and liability. Finally, many companies had well funded pension plans, making the effect of FAS 87 minimal for them (#95-43,44). Most employers are not choosing early compliance with FAS 106, and few companies have well funded postretirement benefit plans. Anna Rappaport of William M. Mercer Meidinger Hansen Inc. exclaims, "Anyone who says because FASB 87 wasn't a big deal this won't be a big deal is wrong, wrong, wrong" (#107-17). How much managers can cut costs through benefit plan redesignment
remains to be seen.

Companies will begin to find ways to control the new reported costs resulting from the requirements of FAS 106. Managers should begin coping with this problem immediately. There are three main steps to this process:

1) Gather information (Ch. 6)
2) Consider plan design changes (Ch. 7)
3) Explore funding opportunities (Ch. 8)

To better understand the second two steps, companies must first have necessary data on their postretirement benefit plans; this information has often been missing in the past. Second, management should consider changing their postretirement benefit plan design to decrease the annual expense under FAS 106. Finally, companies should consider prefunding their postretirement benefit plans in order to decrease their liability.
The first and most crucial step in the management process is to gather information on the company's postretirement benefit plan. The FASB had recommended that companies begin to gather this information even before the Exposure Draft was issued. In 1988, FASB chairman Dennis R. Beresford warned employers to prepare for the future: "Many companies, based on this long lead [before the effective date], may think it's too early to start worrying, now, about the accounting they might have to follow several years into the future. We've urged them to at least start gathering data, so they can determine the company's exposure, first of all. And secondly, to be in a position to be able to respond to the FASB's exposure draft, based on their specific facts and circumstances when we issue our proposal" (#51-20). At a minimum, the FASB asked companies to compile information about the gender and date of birth of employee benefit plan participants, including dependents, as well as the amount of claim costs for the past few years to help estimate future costs (#52-15).

Unfortunately, many companies ignored this warning and continued to lack the necessary information.
This deficiency was discovered by the 1989 field test conducted by Coopers & Lybrand. This study found that information on retiree health plans, demographics, dependency status, and claims data was often unavailable or of poor quality (#15-6). The Financial Executive Research Foundation (FERF) director of research, Roland Laing, explains the information shortage: "What surprised us was the extent to which these large and well-organized companies had difficulty gathering the data they needed to complete the survey. We never guessed it would be such an awkward and arduous task to merge the necessary variety of personnel data and insurance claims" (#11-17). Diana Scott was also surprised by companies' lack of knowledge of their own postretirement benefit plans: "We were absolutely appalled. They honestly weren't measuring this liability. In some cases, they didn't even know whom they were covering as dependents. Employers are finding they promised much more than they can ever give" (#76-94).

To be fully prepared for the effects of FAS 106, management must better understand their postretirement benefit plans. This understanding requires more complete information. At a minimum, companies need to gather information in three main areas:

1) Demographic information

2) Claims data
3) Projections of FAS 106 impact

Companies must first gather demographic and claims information about their postretirement benefit plan participants in order to make predictions of FAS 106's future impact.

The first area of data is demographic information. Companies should first know the type of people covered by the postretirement benefit plan. Employers should gather and analyze information on age, health status, and benefit eligibility of current employees, retirees, spouses, and their children (#56-22). A company should at least know whom its postretirement benefit plan currently cover and whom it will potentially cover in the future.

The second area of data needed is claims data. Employers should learn what types of people are using which benefits. Management should break down postretirement benefit costs by age, especially between early retirees and retirees over 65, and by gender between retirees, spouses, and dependents (#56-22,23).

Most companies have had difficulty tracking their retiree claims costs. For example, prescription drugs, which are some of the most valuable health benefits to retirees, are also some of the most poorly tracked. Most mail-order drug programs report bulk billing back to the employer, and don't indicate what was attributed to
employees, retirees, males, females, over 65-year-olds, or under 65-year-olds. Others do not show Medicare-eligible charges, making it difficult to track cost trends (#35-106). There is often no identification and tracking of segments and individuals who are high users. Likewise, there is little tracking of high-cost and high-use services (#21-64).

Gathering data is a long, expensive process. Actuarial valuations are quite costly to companies. Receiving even basic information can be difficult. One corporation spent $30,000 just to retrieve raw data from two insurance carriers. The actual processing of this information took 12 employees a substantial amount of time (#11-17). The cost of a study by an actuarial consulting firm ranges from $15,000 to $50,000, and takes two to three months (#21-61). However, it can be much more costly to lack this information in the future than to gather it now and understand postretirement benefits better.

This data is vital in helping managers make projections of the impact of FAS 106 on their companies, the third major area of information. Demographic and claims information is first necessary for estimating average per capita (baseline) costs. By applying a health care cost trend rate and other assumptions described in Chapter 3 to these current baseline costs, companies can
estimate postretirement obligations and expenses (#56-23). Companies must decide whether or not to change their substantive plan before 1993, in order to communicate their intentions to the employees (#17-35). It is important that management project the financial impact of FAS 106 on their companies. This information is important as managers consider plan design changes and funding options. A company's financial statement users should also be warned of the impact of FAS 106. A booklet of tips by Coopers & Lybrand recommends that managers "Begin discussions to alert your bankers, analysts, major shareholders and other users of your financial statements to the possible impact of the proposed revisions to accounting standards" (#36-70).

Corporations will be required by the Securities and Exchange Commission (SEC) to have this information two years before the effective date of FAS 106. The SEC's Staff Accounting Bulletin No. 74 (SAB 74) will require companies with fiscal years ending in 1991 to disclose management's discussion and analysis of the expected impact of FAS 106 in future periods. Some of these disclosures are:

1) A brief description of the new standard and the planned or required adoption date
2) The methods of adoption expected to be used
3) The expected financial statement impact of
4) The potential impact of other significant matters resulting from adoption (e.g., technical violations of loan covenants)

There is no requirement that unique measurements be made solely for SAB 74 disclosure. Also, estimates based on current plans are not to be used if management intends to change these plans. Management can thus make estimates based on plans expected to exist at the time of adoption (#94-11,12 , #109-47).

Gradually, employers have begun to gather the data needed to understand their postretirement benefit obligation. A 1987 Greenwich Associates survey discovered that a mere 10% of companies had determined the present value of their liability (#86-11). A 1988 Foster Higgins & Associates survey found this figure to be 25%. A similar survey by Foster Higgins in 1989 determined that 50% of respondents had calculated their postretirement benefit liability. Still, almost 10% of respondents to the 1989 survey didn't even know how many retirees were covered under their plans. Foster Higgins principal Patricia Wilson summarizes, "They [employers] learned that the liability was bigger than a bread box. For some it's bigger than a bakery" (#30-20,21).
CHAPTER 7: 
PLAN DESIGN CHANGES

After companies have the necessary information, they can begin considering plan design changes to control their postretirement benefit costs. Most companies have already begun modifying their postretirement benefit plans in the past few years. Very few companies are increasing their plans. A 1988 Brown Bridgeman & Company survey found that only three of 40 corporations had recently improved their benefit programs, and these were only minor changes (#21-59). A GAO survey of 29 Chicago companies found that all had reduced their health benefits between 1984 and 1988, and that many were considering additional changes. In a follow-up survey, the GAO learned that 21 of the 29 companies had made additional reductions (#25-12,13). A 1990 nationwide survey by Hewitt Associates found that 70% of respondents had cut back on coverage in the last two years (#37-34), and that 80% plan to make changes by 1992 (#97-56). As a result, Judith C. Hushbeck of the American Association of Retired Persons predicts, "Ten to 15 years down the road, workers who retire will have a whole lot less security than retirees today" (#37-34). Likewise, Harold Dankner, a partner with Coopers & Lybrand, warns employees to "Brace for a change, including more cost
shifting" (#98-10). Richard Ostuw, of TPF&C also predicts, "For many the costs will be unaffordable, forcing more and more companies to re-evaluate their benefits commitment to retirees" (#88-76).

There are many ways a company can redesign its postretirement benefit plan to control costs. Some methods will work better for some companies than others. A few companies may be unable to legally alter their benefit plans. However, most employers should consider the advantages of the following five modifications:

1) Benefits linked to age & years of service
2) Defined dollar
3) Flexible benefits
4) Increased cost sharing
5) Managed care

The first method involves linking benefits to age plus years of service. This type of plan would make health benefits more comparable to pension benefits, which increase with an employee's length of service to the company. This method would be a more equitable distribution of compensation. It rewards employees who have been with the company many years, and it encourages younger employees to continue working past the vesting date and retire later (potentially after age 65). This would then decrease the expensive amount of pre-Medicare benefits
that many companies are currently providing.

There are different ways to apply a years of service method. For example, NCNB's plan now requires that a retiree's age plus years of service at the company must total at least 75 before he or she is eligible for benefits (#37-34). A company could also pay 4% of a retiree's health cost per year of service. Therefore, a retiree with only 10 years of service would have 40% of his health costs covered by his former employer, while a retiree with 25 years of service would have all his medical bills footed by his company (#88-76). This would be a more equitable distribution than providing the same benefits to both the 10 year and 25 year employee, as many companies do today. About 10% of companies responding to a 1990 Hay/Huggins survey have switched to a form of the years of service method, while an additional 12% have increased the minimum years of service required to receive benefits (#33-17). AT&T and Pillsbury now use a form of this plan (#34-10, #61-66).

A second plan employers can install to control postretirement benefit costs is a defined dollar plan. Most companies today use a "defined benefit" plan, which promises an unlimited or certain percentage of benefits. On the other hand, a defined dollar plan, often called a "fixed dollar" or "dollar denominated" plan, would place a
dollar limit on the retiree costs a company pays. One way of doing this is placing a lifetime limit of benefit payments a retiree receives, and another is to establish annual dollar limits for each retiree (#45-35). This would eliminate the open-ended promise of unlimited benefits that created the huge postretirement benefit liability. Several companies have begun to adapt defined dollar plans. General Electric Co., which has been capping its postretirement benefits since 1967, limits payments for outpatient drugs at $8 per prescription (#96-43). AT&T had been paying the full cost of retiree health benefits until 1990. Now it is providing only $1800 annually to Medicare retirees who need family coverage, and there is no promise to increase this amount in the future (#37-34). A 1990 survey by A. Foster Higgins & Co. Inc. found that 23% of employers planned to implement fixed dollar benefits, up from 1% in 1989, making this method the fastest growing (#39-1).

Employers must determine a fair dollar amount of benefits to provide retirees. This amount may increase with an employee's years of service to the company. For example, a retiree with 10 years of service may be limited to $18,000 of total health care costs he can charge to the company. This number could gradually rise until a 30-year retiree has $63,000 of lifetime credits (#55-41). It may also be unfair to allocate the same dollar amount to all
retirees, whose dependent statuses vary considerably. Therefore, a company may wish to give a higher dollar denomination to retirees with more dependents (#85-212). A company may also want to increase the dollar amount with the inflation rate to maintain a consistent employer to employee payment ratio. A disadvantage with this is that these "ad hoc" increases could become part of the substantive plan, and FAS 106 would require recognition of the anticipated increases in the defined dollar amount (#18-48). As a result, a defined dollar plan may not be as effective as controlling costs. Using a fixed dollar benefit plan could decrease the postretirement benefit liability by 58.9% and the first year expense under FAS 106 by 67.5%. However, if ad hoc increases are anticipated, these figures drop to 8.3% and 10.5% (#18-50). Employers would eliminate the confusing medical inflation assumption in determining the company's postretirement expense and liability by using fixed future dollar amounts. However, management will need to consider the medical inflation rate when deciding on a reasonable future dollar amount of payments. Another form of the defined dollar plan is the "defined contribution" plan. In this method, the company limits the amount of postretirement benefit coverage to what the company has contributed to each employee's medical account.
The third type of plan to be considered is providing more flexible benefits. This could involve covering core medical benefits for all retirees plus optional coverages like dental and vision care that retirees may "purchase" (#24-82). Retirees could be given credits based on age, length of service, or number of dependents. They could then use these credits throughout their retirement to purchase the optional health care coverages. One option could be reimbursement of all of a retiree's Medicare Part B premium (#85-214). The main advantage of a flexible benefits plan is that it reduces a company's postretirement benefit costs while leaving the retirees a good deal of flexibility in their choices. The main disadvantage is that flexible benefits could become difficult to communicate to older retirees (#111-36).

The extreme form of a flexible benefit plan would be to eliminate postretirement benefits but increase pension payments. It would be entirely up to the retiree how to spend the extra pension income. This method would not only decrease costs to the employer, it would help avoid the confusing requirements of FAS 106. Whitman Industries recently adopted such a plan. Employees age 55 and older had past pension benefits upgraded, but from now on the employee will pay their entire medical cost (#103-12). The 1990 A. Poster Higgins survey found that 8% of companies planned to implement flexible benefits, making
this one of the least common methods (#39-1).

A similar, but less common method of controlling costs is providing "scheduled benefits". These are benefits provided at regular intervals such as dental check-ups every six months (#85-213). One advantage of this plan is that future costs would be more predictable.

The fourth method to decrease postretirement benefit costs is to increase cost sharing by employees and retirees. Retirees could be made to pay a deductible, indexed to Medicare deductibles or medical inflation, before any coverage is provided by the company (#24-82). Raising these deductibles would also help decrease costs by discouraging unnecessary use of medical services (#5-25). Basing retiree contributions on years of service could decrease the postretirement benefit liability by 3.2% and the first year expense under FAS 106 by 2.4% (#18-50). A 1988 TPF&C survey revealed that 38% of Fortune 1000 industrial and service companies had recently raised deductibles, out-of-pocket maximums, or hospital co-payments (#78-61). Similarly, a 1989 U.S. Chamber of Commerce survey found that 1/3 of the respondents had either added or raised deductibles in the last two years (#43-44). A 1990 Hay/Huggins survey found that over 1/3 of the studied companies had recently required greater retiree contributions, and almost 1/4 had also made this change for
dependents (#33-17). The 1990 Foster Higgins survey determined that 33% of companies planned to require higher deductibles in the future (#39-1).

Similar to increasing retiree co-payments, companies could require active employees to contribute to a fund which will help them finance their health care costs in the future. According to the 1988 TPF&C survey, 16% of Fortune 1000 companies had recently increased their required employee contributions (#78-61). The 1989 U.S. Chamber survey determined that 1/3 of the companies had increased the percentage of health insurance premiums paid by active employees in the last two years (#43-44). The 1990 Foster Higgins survey found that 68% of companies planned to increase contribution requirements in the future, making this the most popular method (#39-1). The most famous example of required employee prefunding is found in American Airlines Inc. In 1990, American began charging some 50,000 employees $10 per month to be eligible for postretirement medical benefits. The result is that employees will pay for about 30% of their retiree health care costs (#96-43). American Airlines is using an IRC Section 501 (c)(9) (VEBA) trust to prefund the employees' future health costs (#58-52). VEBA funding vehicles will be discussed in the Chapter 8.

Employers can determine the amount of health costs the employee should pay by using a "Medicare carve
out" approach. Assume if there were no Medicare coverage an employer might pay a standard 90% of the retiree's medical expense, so the retiree would always have to pay 10%. Therefore, assuming there is Medicare, the employer plus Medicare should combine to provide 90% of the retiree's medical bill to keep the retiree's percentage at 10%. So if Medicare contributes 65%, the company should provide 25%, leaving 10% to be paid by the retiree. Under the older "Medicare coordination method", the company would pay for whatever Medicare didn't cover, up to 90%. In this circumstance the company would contribute 35% (instead of 25%) and the retiree would pay nothing (#55-40).

Companies may shift more cost to retirees by discontinuing coverage for spouses, dependents, and younger employees. Using FASB examples, eliminating coverage of employees under 45 could reduce annual cost by 20%. If coverage is dropped for all employees under 55, annual cost could be reduced by 67% (#90-14). In 1987, International Paper "grandfathered" all pre-1983 retirees, but everyone else was forced to pay higher premiums. Finally, any employees hired after October 1, 1987 would not receive any postretirement benefits (#61-66). The 1990 Hay/Huggins survey found that 16% of respondents had reduced their benefits, and another 1.5% had eliminated coverage altogether (#33-17). The 1990 Foster Higgins survey found that 25% of respondents planned to decrease benefits, 5%
planned to terminate their plan, while only 6% planned to increase postretirement benefits (#39-1).

Companies can decrease their postretirement benefit costs through managed care. This method may be the favorite among future retirees because its goal is to decrease costs without decreasing necessary benefits. There are three main components of managed care:

1) Utilization review
2) Price management
3) Wellness programs

The first portion of managed care is utilization review. This process is designed to limit unnecessary health care services. Strategies include requiring advance approval of non-emergency hospitalization, monitoring inpatient lengths of stay, and managing large cases like cancer treatment (#56-24). Second opinions for certain types of surgery may also be required. Utilization review gained popularity in the 1980's. A 1985 William M. Mercer-Meidinger-Hansen survey learned that 47% of employers were installing utilization review programs (#41-40). A 1988 TPF&C survey found that 28% of respondents had implemented mandatory second opinions or hospital pre-certifications (#78-61).
The second segment of managed care is price management. To get the lowest price for health services, companies may require the use of a "preferred provider organization" (PPO). PPOs consist of networks of hospitals and physicians that charge reduced fees in exchange for the greater number of patients and quicker payments that companies can provide. Similarly, companies may also use a "health maintenance organization" (HMO). HMO providers are paid a fixed fee for each subscriber (#56-24). One disadvantage of HMOs is that retirees may find their "comprehensive" health care restrictive (#74-53). The 1985 Mercer-Meidinger-Hansen survey learned that 49% of the respondents were encouraging PPOs and HMOs (#41-40).

The third part of managed care is wellness programs. This is a cost preventive strategy. Wellness programs are designed to hold down future postretirement benefit costs by promoting healthier employee lifestyles in the present. These programs may include screening to detect disease early, assessing health risks of employees (e.g. exercise habits, family history, smoking/alcohol/drug use, and excessive weight), and educational programs to encourage healthier lifestyles (e.g. stress management, nutritional, exercise, and weight loss classes) (#56-25). Southern California Edison (SCE) gives a $10 rebate off the
price of the monthly health care contribution to any employee and spouse who successfully complete an annual good health test. This test screens five modifiable risk factors: smoking, high blood sugar, high blood cholesterol, excessive weight, and hypertension. If the employee fails this test, he or she can start a risk reduction program such as smoking cessation, with SCE picking up $100 of the cost (#100-28). Wellness programs not only decrease future costs, they can also keep current employees healthier and thus more productive.

Another obvious way to decrease postretirement benefit costs is to increase the average retirement age. Companies may want to discourage early retirement, or at least stop encouraging it. This action would reduce the high pre-Medicare costs described in Chapter 1.
In order to reduce the new FAS 106 liability for postretirement benefits, as well as provide security for future retirees, some companies are exploring funding options. A 1988 Greenwich Associates survey found that only 14% of the surveyed companies were prefunding their retiree health plans, and only another 10% planned to prefund in the future (#86-11). A 1990 Hewitt Associates survey determined that 11% of employers prefund their postretirement medical benefits, but another 21% plan to begin funding by 1992 (#97-56). Although neither the FASB nor the federal government require prefunding, it may still be advantageous for some companies to do so. The return on plan assets helps decrease the annual postretirement benefit expense under FAS 106. Eventually, this could make the net periodic cost reported on the financial statements less than the actual benefit payments (see graph).
Plan assets also directly decrease the reported liability, helping to prevent loan covenants from being violated. Companies in rate-regulated industries may want to prefund in order to recover their accrued retiree health costs in their rate bases. Also, companies with government contracts should consider prefunding. In general, for these companies to recover their postretirement benefit expenses from the government, the amounts must be paid currently or placed in a dedicated funding vehicle (#18-49, 51).
There are several drawbacks to prefunding postretirement benefits. Prefunding ties up capital that may be needed elsewhere. It is estimated that funding the auto industry's $39 billion liability over 15 years could add $125 to the price of a car and cut Detroit's profits by 24% (#75-99). Most importantly, unlike with pensions, there are very few tax advantages to prefunding postretirement benefits.

Besides cutting back on Medicare in the 1980s, Congress began removing the tax benefits related to postretirement benefits. Designed to increase federal revenue through taxes, the Deficit Reduction Act of 1984 (DEFRA) began taxing income from plan assets in postretirement benefit funds. However, this did not apply to income from pension plan assets. Two years later, the Tax Reform Act of 1986 removed the few remaining tax advantages of prefunding postretirement benefits. This Act placed a $50,000 lifetime cap on the tax-deductible amount of a policy loan used to pay premiums (#80-103). The Act also restricted corporate owned life insurance (COLI); the last tax-favored prefunding vehicle (#5-25).

Some people asked for a return of some tax benefits. In September 1988, Representative Rod Chandler (R-Wash) proposed a bill entitled the Retiree Health Benefits and Pension Preservation Act. This bill called for annual tax deductible contributions of $2500 for annual
medical premiums and $2500 for long term care premiums per employee (#64-19). Earnings would accumulate tax free until paid out (#5-25). Rep. Chandler once said, "it's time we recognized that the need for adequate retirement income and financing retiree health care are part of the same fabric" (#71-51). It is estimated that under the new FASB guidelines, 70% of major corporations would fund if given a tax break. With no tax benefits, only 25% would fund (#21-63). However, providing tax advantages to funding postretirement benefits similar to pension benefits would cost the government $6 billion annually in lost tax revenue (#7-18).

A compromise was reached by allowing companies to use excess pension assets to fund postretirement benefits. Rep. Chandler's bill first called for this allowance (#67-9). This proposal would benefit companies with overfunded pension plans. Excess pension assets are estimated at over $200 billion, and annual corporate cash pay out only $5 to $10 billion for retiree health care (#71-50). Also, the federal government would benefit from increased tax revenues. Payments from excess pension plans are not tax deductible, whereas payments from general corporate funds would be. The Joint Committee on Taxation estimated that this proposal would increase federal tax revenue by $3 to $4 billion over a five-year period (#92-3). The Coalition for Retirement Income Security (CRIS) estimated this figure
to be as high as $6.5 to $7 billion over a five-year period (#22-21). In 1990, the Omnibus Budget Reconciliation Act allowed for the transfer of excess pension assets to postretirement benefit funds under several strict conditions. These conditions will be discussed shortly.

Although the government has removed most incentives for companies to prefund, there is also no requirement to prefund postretirement benefits like pensions. In 1974, the Employee Retirement Income Security Act (ERISA) was passed. This Act set funding, participation, and vesting standards for private pension plans. ERISA forced employers to be more accountable for their pension plans, making sure companies set aside enough funds to cover their pension obligations. ERISA does not apply to any postretirement benefit plans. However, if the government provides more funding incentives, employers may also be required to follow more rules under an "ERISA II" (#21-59).

Today, companies can choose from several funding options. Through some manipulation, these options can yield tax benefits. Currently, there are four major prefunding vehicles available:

1) 401(h)
2) 501(c)(9) (VEBA)
3) Corporate Owned Life Insurance (COLI)
4) Employee Stock Ownership Plan (ESOP)
Managers will rely more on accountants to determine the most appropriate funding vehicle, if any.

The first, and one of the best, funding vehicles is the Internal Revenue Code (IRC) Section 401(h) plan. Under Section 401(h), a defined benefit pension plan may provide for the payment of the health care costs of retired employees, spouses, and dependents through contributions to a separate account maintained for this purpose under the plan. The contributions made to the 401(h) account are treated like contributions to a pension fund. Thus, the contributions are tax deductible in the year they are made. Also, the earnings on the assets accumulate tax free (#46-256). In addition, retirees receive these benefits tax free. The 401(h) assets are not available to creditors, making them very secure (#16-24). This funding mechanism could greatly reduce postretirement benefit expenses and liabilities for some companies. For example, if this form of funding was maximized between 1989 and 1992, the FAS 106 liability and expense could be reduced by 39% and 33.7% respectively for Occidental Petroleum Corporation (#98-11).

Unfortunately, there are many restrictions to Section 401(h) plans. The medical benefits in the account "must be subordinate to the retirement benefits provided by such plan." Subordinate means that postretirement benefits do not exceed 25% of the aggregate contributions made to
fund the plan (#67-8). Also, a separate medical account must be established and maintained for each key employee (#47-66). In situations where a company has a small pension fund, the 25% contributions to the separate medical account become too small to be beneficial. Thus, only companies with pension costs over 3% of payroll will benefit from a 401(h) plan (#16-25). Due to these strict and often confusing complications, under 5% of companies used 401(h) plans in 1986 (#67-7).

The Omnibus Budget Reconciliation Act of 1990 allowed for the transfer of excess pension assets to postretirement benefit accounts if several conditions were met. Pension benefits must be fully vested before they can be transferred. Also, any amounts transferred in excess of the year's retiree health benefit payments must be transferred back to the pension plan at a 20% excise tax. Finally, retiree health benefits must be maintained at the same dollar level for covered retirees for at least four years after the transfer. These rules make 401(h) plan transfers undesirable for all companies except those with highly overfunded pension plans. Since pension assets will now be used up faster some companies may be required under ERISA to make pension contributions sooner than originally planned (#18-51).

A second, and more common, funding mechanism is a
Voluntary Employees' Beneficiary Association (VEBA) trust established under IRC Section 501(c)(9). VEBAs were quite attractive before the 1984 Tax Act placed severe limitations on their usage (#46-256). Still, in 1986, about 30% of companies were using a VEBA to fund postretirement medical benefits (#67-7).

There are many limitations to VEBA trusts. They cannot be used to provide pension benefits. Like 401(h) plans, separate accounts must be created for key employees (#67-8). The benefits are not taxable to retirees, and the employer receives a few tax benefits. The tax deductible contribution to a VEBA account is limited to current costs, administrative expenses, and a reserve for future costs, assuming no health care inflation (#18-52). Thus, for employees nearing retirement, 40% to 60% of their future benefit cost cannot be considered in funding calculations (#16-25). Also, the lesser of the fund income or the amount by which the fund assets exceed the qualified asset account limit is considered unrelated business taxable income (#47-65).

A third funding method is Corporate Owned Life Insurance (COLI). In this strategy, the company pays the entire premium, and is the sole beneficiary of the death proceeds. These proceeds cover the costs of the health benefits provided. One disadvantage of COLI is that the
Tax Reform Act of 1986 limited the deductibility of policy loans to $50,000 per covered employee. To cope with this requirement some companies have enlarged their plans to cover more employees. Another disadvantage of COLI is that the premiums are not tax deductible. This problem can be solved by using VEBA Owned Life Insurance (VOLI) (§47-66). Using VEBA funds to purchase life insurance also eliminates the unrelated business income tax found in an ordinary VEBA. Overall, the main advantage of life insurance over other types of funds is the tax deferral of earnings and the tax free benefits upon death (§16-26).

The fourth method of funding postretirement benefits is through an Employee Stock Ownership Plan (ESOP). This method places more responsibility on the employee than any other funding mechanism does. An employer can give employees stock in the company to pay for medical benefits in the future. The longer the employee remains with the company, the more dividends he or she will receive, and the more the stock will appreciate. This will help discourage early retirement. Another advantage is that dividends paid out from an ESOP will reduce the company's taxable income, although they will be taxable to the employee (§26-21). An ESOP gives the employee greater flexibility, since there is no requirement to use the dividends for medical benefits (§18-53). ESOPs are gaining
popularity. Ralston Purina has replaced its entire retiree medical plan with an ESOP (#110-15). Also, as discussed in Chapter 7, American Airlines has adopted a similar plan.
CHAPTER 9:
OVERALL REACTIONS TO FAS 106

Companies have had mixed reactions to the requirements and the implications of FAS 106. Many object to its complexity. Some respondents felt that the complexity of the six cost components will add neither relevance nor reliability, only time and expense (#42-46). Others oppose it because of the financial statement impact the statement will have on businesses. Still others feel that the FASB is moving too fast.

There were several negative responses to the overall content and results of FAS 106. According to Eugene Flegm, the assistant controller of General Motors, "The new FASB proposal is too harsh, too unmanageable and would have too much of an impact on financial results" (#14-49). Shell Oil's response letter warns that, "We can ill afford another major standard that may score well on the scale of conceptual purity, but one that will not receive general acceptance because of its stringent recognition criteria, its complexity, its failure to acknowledge the pragmatic issues confirmed during the project, and because it tries to accomplish too much, too soon" (#102-15). Dan Coulson, accounting director for Ford Motor Co., feels the same: "One overall concern is that too
fundamental and major an accounting change is being considered in too rapid a way. It appears that FASB is trying to get to the same conceptual stage as it did with pensions but without the evolutionary fashion" (#78-61). General Motors Corp. Executive Vice President R.T. O'Connell argues that "the measurement and implementation criteria specified by the FASB will result in unrealistic, irrelevant estimates which can only cause confusion and a loss of credibility" (#108-70). Standard and Poor's (S&P) made the most famous reaction by planning to ignore FAS 106 when issuing credit ratings. They say, "The ability to quantify future medical liabilities of retirees will be difficult given the need to make assumptions which may or may not prove valid" (#73-21). S&P will focus on current cash outlays rather than benefit accruals (#59-16).

The FASB continues to defend its position, claiming that the impact of FAS 106 should not affect their decisions. The Board notes that paragraph 98 of CON 2 defines accounting neutrality as focusing on relevance and reliability and "not the effect that the new rule may have on a particular interest" (#105-109,110). Thomas G. Nelson of the FASB's postretirement benefit task force states that the Board is "trying to do what is theoretically correct, in an accounting sense, anyway, regardless of the consequences. I don't mean that harshly. It's actually kind of a nice thing to say - that, despite the current
discomfort it causes, we're going to do whatever is conceptually appropriate and consistent with the rest of the financial statements" (#99-30). The Financial Accounting Standards Committee of the American Accounting Association (AAA) supports the FASB's neutrality, saying, "The objective of financial reporting is not to encourage or discourage specific financial decisions. Rather, financial reporting should provide objective and unbiased information to investors, creditors and others about the financial performance and condition of the firm" (#1-112). The AAA summarizes, "Accounting is not expected to change the economics, but to reveal data to enable an assessment of the economics" (#1-110). The FASB emphasizes that a true accounting liability exists for postretirement benefits. Project manager Diana Scott states, "I personally am not real sympathetic with not accounting for something because it is too hard, when management has already made the promise" (#73-21,23). The large number of objections only reinforces the FASB's belief in the importance of these benefits. Chairman Dennis R. Beresford explains, "If postretirement benefits were incidental, few would be concerned with how they were reported in financial statements" (#59-14).

In spite of the many critics and criticisms, FAS 106 has brought support and praise for the FASB. Diana
Scott reminds would-be critics that the FASB "didn't create the problem" (#49-9). Karen Ignagni, health-policy director for the AFL-CIO admits, "All the FASB is doing is turning a light on a problem that has existed for some time" (#65-49). Congressman J.J Pickle of the House Ways and Means Committee states, "It seems to me that the new accounting rules are just forcing businesses to publicly acknowledge their existing commitments" (#79-62). Despite its many criticisms of the requirements of the Exposure Draft, Shell Oil praised the FASB's efforts. The beginning of the comment letter says, "In our view, the Board's project on postretirement benefits has the potential to go far beyond what was accomplished in the pension accounting project" and "We believe the Board's efforts in communicating with its constituency about the project have been outstanding" (#102-14). The FASB has received the most support from the AAA. Arthur Wyatt of the AAA exclaims, "That the business community is heaping scorn, rather than praise, on the Board for its proposals is distressing, even deplorable. What the FASB project has really done is to shed light on a serious business problem facing many companies, possibly even saving some managements from the effects of their own often uninformed and uneconomic decisions" (#112-108). The AAA complimented the FASB for helping companies and investors. The beginning of their comment letter states, "Regardless of
the final content of the accounting standard, the FASB's decision to study this issue has already encouraged companies to examine much more carefully the commitments made in postretirement benefit plans. We believe this examination has already helped companies make better business decisions. Furthermore, we believe the discussion concerning the impact of this obligation on the financial condition of a business enterprise has sensitized investors to the potential cash flow impacts of this cost. Therefore, more informed decisions will be made about companies which are significantly affected by these costs" (#1-111). Employees should also benefit from these new discoveries. Diana Scott says, "As an employee, I'd much rather know now that you can't deliver on what you've promised than be in retirement and have them say, 'Gee, we're real sorry but there's no more money left to pay the benefits that we promised'" (#15-6).

FAS 106 has changed accounting for postretirement benefits dramatically. As we have seen, the shift from the cash to accrual basis will have a huge initial impact on the financial statements. This will lead to the secondary effects of plan design changes and prefunding. Despite the controversies surrounding the requirements and the results of FAS 106, the Financial Accounting Standards Board has stood firm in its efforts to improve financial reporting.
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OTHER SUGGESTED READING
