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An Analysis of the Exposure Draft on Retirement Benefits Other than Pensions

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AN ANALYSIS OF THE EXPOSURE DRAFT
ON POSTRETIREMENT BENEFITS
OTHER THAN PENSIONS

by

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INTRODUCTION

The rising cost of providing adequate health care to current and retired employees has become a major concern of many employers. Most companies pay and expense these costs as they are incurred, but employers may have no idea what future costs will be assumed. At present, employers are not required to estimate and report potential obligations for retiree health care costs on their companies' balance sheets. However, employers will be required to report obligations for retiree benefits in the near future.

On December 21, 1990, the Financial Accounting Standards Board (FASB) issued Accounting Standard #106 titled "Employer's Accounting for Postretirement Benefits Other Than Pensions," effective for large companies beginning December 15, 1992.[1] For companies with a large number of retired employees, the obligation to provide retiree benefits may be those companies' single greatest liability, a liability that is not recognized in most financial statements today.

The FASB believed the current method of recording postretirement benefits other than pensions did not adequately reflect the nature of companies' obligations to their employees. Most employers are currently using a "pay-as-you-go" method of accounting which does not disclose potential liabilities incurred by employers for retiree benefit plans. The Statement changes the reporting requirements from mere disclosure to

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[1]Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions. Financial Accounting Standards Board. December 1990. Introduction.

actual accrual of the liability in financial statements. The accrual is based on a number of assumptions which are to reflect potential claims against employers.

The FASB's principal objective in producing the accounting standard was to work toward improvements in financial reporting. The Board judged that the current method of disclosure was not adequate because measurable costs of benefits attributed to postretirement benefits plans created obligations which were not recognized in financial statements during the service lives of the employees.

The purpose of this paper is to review the development of the Statement of Financial Accounting Standards (SFAS) No. 106, determine the effect of comments made on the exposure draft in the final statement, and to suggest further ideas for change. A brief overview of two theoretical problems with the current practice of accounting for postretirement benefits will begin this discussion.

CURRENT PRACTICE

There are two theoretical problems with the current cash basis or "pay-as-you-go" practice of accounting for retiree benefits. First, the cost of retiree benefits is not recognized in the period incurred, but in the period paid. Accrual accounting would allocate the costs over the period from date of hire to full eligibility of the employees instead of charging the costs to earnings in the period paid.

Second, the obligation to pay future benefits is not included in most companies' financial statements. As a result, companies' financial statements are incomplete and do not represent an accurate financial portrayal of the companies. Because the financial statements are incomplete, users of the statements may not be able to draw accurate conclusions about a company's financial condition.

With these two problems acknowledged, FASB began to determine the basis from which the accounting standard would be developed. The first step was to examine whether retiree benefits met the definition of a liability.

IS THERE A LIABILITY FOR OTHER POSTEMPLOYMENT BENEFITS?

While researching the issues of whether cash-basis accounting was an adequate method of accounting for postretirement benefits, the question must have been asked by the FASB as to whether employers were obligated to pay for retiree benefits. If there was no obligation, the benefits could not be accounted for as a liability. In determining whether there was a liability, FASB had to review the basic tenants of what constitutes a liability.

Liabilities are defined in paragraph 35 of Concept Statement No. 6, 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." [2]

The first characteristic of a liability is a "present duty or responsibility to one or more other entities that entails settlement by

[2] "Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements." Original Pronouncements. Financial Accounting Standards Board. December 1985. Paragraph 35.

probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event or on demand."[3]

Measurement of retiree benefit liability considers the likelihood that some employees will work until they are eligible to receive postretirement benefits while others will terminate their employment before reaching that date and forego any rights to benefit payments.

The second characteristic of a liability is defined as:

> the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice. . . . Although most liabilities rest generally on a foundation of legal rights and duties, existence of a legally enforceable claim is not a prerequisite for an obligation to qualify as a liability if for other reasons the entity has the duty or responsibility to pay cash, to transfer assets, or to provide services to another entity.[4]

Case law has not consistently ruled in favor of one side in battles concerning legal rights of employees to receive postretirement benefits.[5] Indifferent to what the courts have ruled, the Board has decided that the obligation to provide employee benefits is a liability, even if communicated to employees though "past practices, social or moral sanctions or customs."[6]

The third characteristic of a liability is "the transaction or other event obligating the entity has already happened."[7] This third characteristic is met when employees renders service in exchange for the promise of future benefits. Postretirement benefits are a form of

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[3]Ibid., paragraph 36.

[4]Ibid.

[5]Statement No. 106, op. cit., Paragraph 156.

[6]Ibid.

[7]Concepts Statement No. 6, op. cit., Paragraph 36

deferred compensation and should be recognized in the period earned by the employee, not at the time of payment.[8] SFAS No. 106 requires recognition of an approximation of the cost of an employee's postretirement benefits during the period in which those costs were earned by the employee, noting that uncertainty of amount and timing of payments prohibit the recognition of a precise amount of those costs during the service period.

The Board concluded that postretirement benefits other than pensions met the definition of a liability. The next step the Board had to take was to determine if the liability was able to be measured using criteria recognition principles.

Criteria for Recognition

Paragraph 159 of SFAS No. 106 notes there are four criteria an item must meet if it is to be recognized in the financial statements. The four criteria are defined in Concepts Statement No. 5, paragraph 63 as follows:

Definitions- The item meets the definitions on an element of financial statements.

Measurability- It has a relevant attribute measurable with sufficient reliability.

Relevance- The information about it is capable of making a difference in user decisions.

Reliability- The information is representationally faithful, verifiable, and neutral.

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[8]Statement No. 106, op. cit., Paragraph 146.

Based on the characteristics of a liability, "the Board concluded that the postretirement benefit obligation meets the requirements of a liability. The Board also believed that the liability was measurable with sufficient reliability and was sufficiently relevant to warrant recognition in the financial statements."[9] The next section of this paper will briefly review the requirements of SFAS No. 106.

FASB ACCOUNTING STANDARD No. 106

SFAS No. 106 requires companies to begin using accrual accounting for their postretirement benefits other than pensions in 1993. The consensus of the Board was that employees earn postretirement benefits while providing services to the companies during the course of employment. The accrual of the costs to provide retiree benefits should begin when employees are hired and end when the benefits are fully vested. Thus, the "pay-as-you-go" method for recording retiree benefit costs would no longer be acceptable.

Viewing the obligation for postretirement benefits to be similar to the obligation for pensions, the Board developed accounting procedures similar to the accounting for pensions as specified in SFAS No. 87 "Employers Accounting for Pensions."

Similar to the accounting treatment for pensions, SFAS No. 106 computes the current year's cost of the outstanding obligation as a complex calculation made of a number of components.[10]

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[9]Exposure Draft, op. cit., paragraph 140.

[10]Statement No. 106, Paragraph 47.

Service cost. The service cost component would be the increase in the expected postretirement benefit obligation (EPBO) attributed to employee service during that period.[11]

Interest cost. The increase in the APBO attributable to the passage of time would be reflected in the interest cost component. Interest cost would be calculated by applying the beginning of the year discount rate to the beginning of the year APBO, adjusted for benefit payments to be made during the period.

Actual return on plan assets. "For a funded plan, the actual return on plan assets shall be based on the fair value of plan assets at the beginning and end of the period, adjusted for contributions and benefit payments." [12] The actual return on plan assets would decrease the total benefit cost for the period.

Prior service cost. This cost would be the amortization of retroactive benefits resulting from plan amendments and/or plan initiations that take place after the statement is adopted.

Gains and losses. This component would be the amortization of the unrecognized net gain or loss from previous periods. In general, gains

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[11]Expected Postretirement Benefit Obligation is "the actuarial present value as of a particular date of the benefits expected to be paid to or for an employee." Accumulated Postretirement Benefit Obligation (APBO) is "the actuarial present value of benefits attributed to employee service rendered to a particular date." Prior to an employee's full eligibility date, the APBO is the portion of the EPBO attributed to that employee's service rendered to that date; on or after the full eligibility date, the APBO and EPBO for that employee are the same. Ibid, Paragraph 518.

[12]Statement No. 106, Paragraph 49.

and losses are changes in the APBO resulting from changes in assumptions or from experience different from that assumed. For funded plans, this component would also include the difference between actual and expected or unexpected return on plan assets.

SFAS No. 106 allows for a prospective approach at recognizing the gain or loss, similar to the "corridor approach" used in pension accounting, whereby a company could amortize only a portion of the net accumulated gain or loss that exceeds 10% of the greater of the APBO or the market value of plan assets.

Transition obligation or asset. This component is the difference between the accumulated obligation and the fair value of plan assets plus any accrued benefit cost or less any prepaid benefit cost. The difference is amortized over the greater of the average service lives of employees or twenty years.

<u>How Do Those Components Fit Together?</u>

To comply with SFAS No. 106, companies will need to follow many of the same accounting rules as they do for pensions. Specifically, financial statement preparers will first need to project total costs and timing of retiree benefits to future periods. Secondly, these projected payments will need to be discounted using present value techniques. The discounted amount will be spread over a number of years, generally from the date of hire to the date that employees are fully eligible to receive their benefits (attribution period). The amount allocated to each year will be adjusted for interest on the total benefit obligation, and earnings on funded plan assets (if any). The adjusted amount is then amortized for a portion of prior service costs, the gains and losses on the plan assets, and any transition asset or obligation due to changes in the accounting treatment of the plan. The resulting amount is the net benefit cost for the period, similar to the pension cost calculated under SFAS No. 87.

Disclosures

SFAS No. 106 requires a number of disclosures about an employer's obligation to provide postretirement benefits and the costs associated with providing these benefits. The disclosures are designed to enhance the usefulness of information to users of financial statements by providing information such as a description of benefit plans and amounts of net periodic benefit costs.

Other disclosures required by SFAS No. 106 include a schedule that reconciles the funded status of the plan with amounts reported in the employer's statement of financial position. One element of the schedule is the health care cost trend rate. The trend rate is to be shown along with the effect of a one-percentage point increase in the assumed health care cost trend rate on the net benefit cost and accumulated benefit obligation.

THE EFFECT OF THE COMMENTS ON THE EXPOSURE DRAFT IN THE FINAL STATEMENT

As with other new accounting standards, SFAS No. 106 was first released as an exposure draft in order for industry and other interested parties to comment about the requirements. The Board received 467 comment letters on this exposure draft.[13]

The following discussion regarding recognition versus footnote disclosure will review how the development of the final statement was influenced by both the comments received on the exposure draft and a field test of the draft by the Financial Executives Research Foundation.

Recognition Versus Footnote Disclosure

According to the comments received on the exposure draft as tabulated by Martens and Stevens,[14] approximately 60% of the letters supported FASB's view that the obligation to provide postretirement benefits is a liability and should be disclosed on the balance sheet. An additional 9% agreed that the obligation is a liability, but concluded that it should be disclosed in the footnotes. Less than 15% argued that the obligation is not a liability and should not be shown anywhere in the financial statements. Approximately 16% had no comment on the issue.

Relevance should be evaluated in the context of the principal objective of financial reporting--to provide information that is useful in making rational investment, credit, and similar decisions.[15] In general, users of financial statements should find information about the

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[13]Martens, Stan and Kevin Stevens, "Business Reacts to FASB's Proposal for Nonpension Retirement Benefits," Journal of Accountancy. June 1990. Page 21.

[14]Ibid.

[15]"Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises." Original Pronouncements. Financial Accounting Standards Board. November 1978. Paragraph 36.

postretirement benefits relevant to investment, credit and other decisions.

However, some people may disregard this information when analyzing the financial statements of a company. While users of financial statements may incorporate information disclosed in footnotes, a study has shown that users may be more influenced by obligation amounts accrued in financial statements than by footnote disclosures.[16]

Controversy concerning the measurability and reliability of the benefit obligation has caused some critics to suggest that footnote disclosure is the preferred method of representing retiree benefit obligations to users of financial statements.[17] Critics argue uncertainty involved in projecting the retiree obligation is so great that it results in an unreliable measurement.

Paragraph 59 of Concepts Statement No. 2 notes that reliability of a measurement of accounting information is dependent on the extent to which users can depend on it to represent the economic conditions or events that it purports to represent. SFAS No. 106 acknowledges that there is seldom a clear choice; "whether the accounting information is so relevant that some allowance ought to be made for some lack of

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[16]Research results indicated that when users (bankers and accounting students) of financial statements were presented with pension information in a balance sheet, a significantly greater number of the users included the pension obligation in the numerator of a debt/equity ratio than when the same information was presented as a note to the financial statements. The research was conducted by Harper, Mister and Strawser and was reported in The Impact of New Pension Disclosure Rules on the Perceptions of Debt," <u>Journal of Accounting Research</u> (Autumn 1987), p. 327.

[17]Scott, Diana J., and Wayne S. Upton, "Postretirement Benefits Other Than Pensions." <u>Highlights of Financial Reporting Issues</u>, Financial Accounting Standards Board, December 1988, page 3.

reliability because the information provides a better representation of economic conditions than would be portrayed without the information."[18]

The Board further concluded, "to imply by a failure to accrue that no obligation exists prior to the payment of benefits is not a faithful representation of what the financial statements purport to represent."[19] Thus, the Board concluded that failure to recognize the existence of an obligation significantly impairs the usefulness and integrity of financial statements.

The Board also included in SFAS No. 106 a statement which argues for recognition versus disclosure of postretirement benefit obligations:

> Footnote disclosure is not an adequate substitute for recognition. The argument that the information is equally useful regardless of how it is presented could be applied to any financial statement element, but the usefulness and integrity of the financial statements are impaired by each omission of an element that qualifies for recognition. . . . Further, although the "equal usefulness" argument may be valid for some sophisticated users, it may not hold for all or even most users. Those who assert that footnote disclosure or recognition would be equally useful, but argue only for disclosure, must believe that recognition would have different consequences.[20]

The AICPA Accounting Standards Executive Committee (AcSEC) also agreed with FASB's position that employers who provide postretirement benefits other than pensions have an obligation that meets the

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[18]Statement No. 106, op. cit., paragraph 161.

[19]Ibid., paragraph 163.

[20]Ibid., paragraph 164-165.

requirements of a liability as defined in FASB Concept Statement No. 6, *Elements of Financial Statements.*[21]

Field Test

A more difficult task than concluding that postretirement benefits obligations were liabilities was to develop procedures for accurately measuring the cost associated with the obligations. Since payments of the obligations are future events, measurement of the costs can only be provided by the use of an estimate. FASB realized estimates of benefit costs will be subject to a larger margin of error than many other estimates, but viewed a "best-efforts" measurement of the obligation and accrual of cost was better than implying (by no accrual) that no obligation exists.[22]

A 1989 field test study, sponsored by the Financial Executives Research Foundation (FERF) and conducted by the actuarial and benefit group at Coopers & Lybrand, analyzed the effects of the exposure draft on the financial statements of 25 major companies.[23] The study was limited to retiree health care benefits because of the complexity and implementation problems retiree benefits were thought to have caused.

The FERF's field test of the exposure draft concluded that the liability for retiree health care benefits may not be measurable with the intended reliability needed for recognition in the financial

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[21]"Responses to OPEB Proposal," Journal of Accountancy. November 1989. Page 19.

[22]Scott and Upton, op. cit., Page 2.

[23]Dankner, Harold, et al. "Retiree Health Benefits - Field Test of the FASB Proposal" Financial Executives Research Foundation. Morristown, New Jersey:1989. Page 1.

statements. Numerous problems were encountered in the field test with availability and quality of information on detailed medical claims, demographic data, and benefit plan information from the participating companies.[24] These problems required the use of additional assumptions where data was missing or of questionable value. Some of the common data problems encountered relate directly to the reliability of the measurement of postretirement benefits.

Employers' guidelines on the implementation of the benefit plans were frequently out of date and had to be supplemented with internal memoranda on how the plan was to be administered. Benefit plans would state one procedure when in fact another procedure was used in practice. Other companies had little or no written documentation on administrative procedures.

Numerous problems were also encountered in gathering demographic information on relevant retirees and their dependents. The most common problems involved limited data on employee dependents, but also involved employee eligibility information and a lack of information on historic claim payments.

FERF concluded from the field test that many companies will find estimation of average per capita costs for their retiree groups will be a difficult task with the amount and type of data most companies are currently gathering.[25] Many assumptions will need to be made in order to calculate the postretirement benefit obligation for some companies. A discussion of several of those assumptions follows in the next section.

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[24]Ibid., Page 57.

[25]Dankner, op. cit., page 62.

<u>Assumptions</u>

The service cost component and any prior service cost are "measured using actuarial assumptions and present value techniques to calculate the actuarial present value of the expected future benefits attributed to periods of employee service."[26] Major assumptions include the time value of money, salary progressions (if the plan is based on compensation), probability of payment (turnover, retirement age, dependency status, mortality), and amount and timing of future payments.

For postretirement health care benefits, additional assumptions will need to be considered and factored into the OPEB calculation. Assumptions concerning past and present per capita claims, cost by age, health care cost trend or inflation rates, Medicare reimbursement rates, the cost of new technological advancements, changes in utilization and delivery patterns and even the changes in the general health status of plan participants will need to be factored into OPEB calculations.

The assumption that drew the most criticism from opponents of the exposure draft is the health care cost trend rate. The health care cost trend rate considers the "expected annual change in per capita claim costs due to factors other than changes in the composition of plan participants by age or dependency status."[27] Four elements need to be considered in developing the assumed health care cost trend rates:

Future medical care cost inflation. The accounting standard requires each company to formulate their "best guess" as to how inflation in health care costs will affect their total obligation.

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[26]Statement 106, op. cit., paragraph 30.

[27]Ibid., paragraph 198.

Changes in utilization or delivery patterns**.** **The accounting standard requires each company to project how employees will be requiring or electing medical procedures or changing medical care providers.**

Technological advances**.** **Companies will be required to estimate future advances of medical equipment and the costs associated with using that equipment.**

Changes in the health status of the covered retirees**.** **The accounting standard requires companies to project the health care needs of their employees into the future.**

Adding to the complexity of assumptions made to determine the service cost component, SFAS No. 106 notes that different services, such as hospital care and dental services, may require separate and distinct health care trend rates.[28] Factors that would account for changes in trend rates are also required as a part of the service cost component.

During the FERF field test, companies were to comply with the requirements of the exposure draft and develop a unique health care cost trend rate. The test results demonstrated that the "inherent uncertainty surrounding future economic events vastly complicates efforts to predict employers spending for retiree health benefits, particularly over the long run."[29] The twelve companies ranged in their trend rates from 6.3% to 8.9%.

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[28]Ibid., paragraph 39.

[29]Dankner, op. cit., page 76.

The accounting standard also requires a footnote disclosure of the sensitivity of the effect on the liability of a 1% increase in the health care trend rate to illustrate the potential impact of a change.[30] The Board concluded that requiring the effect of a one-percentage point change, while holding all other assumptions constant, would assist users of financial statements in comparing reported information. Although this requirement was initially proposed in the accounting for pensions, FASB decided not to require the information because the cost of providing the information was viewed as outweighing the usefulness to users.[31]

The Board decided that the use of sensitivity information in the assumptions is of greater necessity in the case of postretirement health care benefits because of the subjectivity of the health care trend rate and the significant effect it could have on the obligation.

Nearly 60% of the comment letters received by FASB discussed the issue of requiring sensitivity information on the health care trend rate. Of those letters, approximately 4% agreed with the requirement. The primary objection of the requirement is the health care trend rate is just one of a number of assumptions in the calculation of the postretirement benefits obligation and preparation of financial statements. The FASB does not require sensitivity analysis for any other assumptions, such as useful life and salvage value of equipment for depreciation purposes. The letters also noted that the effect of

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[30]Statement No. 106, op. cit., paragraph 74. This had changed from the exposure draft disclosure requirement of a one-percent increase <u>or decrease.</u> No explanation was given for the change.

[31]Ibid., paragraph 355.

disclosing the 1% change may cast doubts on the integrity of healthcare cost trend assumption as well as others.[32]

Alternative Approaches

Opponents to the exposure draft have suggested that FASB relax the requirements of requiring individual businesses to develop a unique health care trend rate. Price Waterhouse recommended the FASB allow companies the option of using consumer price index projections as the basis for accruing costs of future benefits.[33] Deloitte Haskins & Sells agreed the benefits should be accrued, but stressed alternative approaches that would result in a lower cost to the preparers.[34] The AICPA AcSEC suggested that the FASB use a measure of health care inflation that excluded changes in health care usage or delivery patterns and assumed advances in medical technology.[35]

Of the comment letters received from interested parties, over half addressed the health care trend rate and less than 5% agreed with the proposed approach.[36] Many of the letters stated the rising costs of health care ensures that either companies or the government will take actions to reduce the costs. Thus, the accounting standard is ignoring future probable events and should be considered unrealistic. Others argued that determining a unique health care trend rate would be expensive and possibly impossible to develop. Nearly 51% of those

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[32]Martens, op. cit., page 23.

[33]"Responses," op. cit., page 20.

[34]Ibid.

[35]Ibid.

[36]Martens, loc. cit.

commenting on this issue argued for using a general rate of inflation or some other standard that would be used to enhance the comparability of information among companies.

Some opponents of the exposure draft had concerns with the reliability of the measurements due to the fact that the measurements involve projections of assumptions many years into the future. Various approaches other than the explicit approach (using an actuarial calculation which uses historical information to project future costs) that FASB has taken have been suggested,[37] including the following:

Nonprojected approach. This approach would assume a zero percent cost trend rate. Measurements of obligations and expenses would not consider projections of future trends that could prove unreliable. Others reject this approach noting inconsistency in removing the effect of inflation from the cost trend but anticipating inflation in the setting of the discount rate.

Nonprojected/nondiscounted approach. The FASB considered an approach that was based on the premise that all future projections of inflation are unreliable and should be ignored. However, this approach was inconsistent with FASB's explicit approach that each assumption should be based on the "best estimate" of future events.

General inflation approach. Since health care costs have historically exceeded inflation, some believe that the minimum estimate of the projected liability should be based on a general inflation

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[37]Dankner, op. cit., page 102.

factor. While this approach may add consistency and reliability to the health care trend rate, the approach would not be the "best estimate" of future health care costs.

Medical inflation approach. This approach would consider only expected medical price inflation, rather than assuming increases in costs due to changes in technology and utilization patterns. Proponents of this approach believe that changes due to non-price factors are more difficult to predict based on past experience and could lead to more reliability in the calculations. Others, however, believe a best estimate is not possible without assumptions for changing technology and utilization patterns.

The above alternative cost trend approaches were studied during the field test, and as expected, resulted in large decreases in expenses and the benefit obligation in the year of adoption using accrual accounting. The estimated impact of the alternative approaches in the year of adoption of the accounting standard is shown in Appendix 1.

FASB has concluded that the explicit approach of the accounting standard provides the best estimate of the future obligation and expense. The Board believed users of financial statements would be best able to make judgments about the measurements if given as much information as possible on the assumptions and estimates. Hence, the Board required preparers of financial statements to measure obligations with the best estimates possible.[38]

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[38]ED, op. cit., paragraph 182.

Attribution Period

Criticism also arose concerning the length of time the OPEB obligation was to be accrued in financial statements. The accounting standard attributes the postretirement benefits liability over the service life of the employees from the date of hire to the date that employees become fully eligible to receive postretirement benefits, absent a specific restricting clause in the postretirement benefit contract. The Board's contention was that "if a plan provides a postretirement benefit to an employee who attains age 55 while in service, the actuarial present value of that benefit should be fully accrued when the employee attains age 55."[39]

Attributing the benefits from the date of hire to the date of full eligibility is consistent with SFAS No. 87 which attributes pension benefits to a similar period. A contractual obligation exists at the date of full eligibility and employees can terminate employment and expect to receive the benefits. Attribution of the benefits beyond the date of full eligibility would make the exposure draft inconsistent with the "fully vested" date for attributing pension benefits. The Board saw little difference in the two dates.[40]

In a letter to the FASB, Financial Executives Institute (FEI) President P. Norman Roy stated that the FEI does not agree with the attribution period suggested by the Board.[41] Roy believes the right to receive postretirement benefits is normally contingent upon the actual

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[39]Ibid., paragraph 221.

[40]Ibid., paragraph 235.

[41]"Responses to OPEB Proposal," Journal of Accountancy. November 1989. Pages 19-20.

retirement and employers often reserve the right to modify postretirement benefit plans. The FEI called for FASB to revise the exposure draft to lengthen the attribution period from the date of hire through the date of expected retirement, based on each companies' experience with their total workforce.

The FEI was not alone in voicing criticism of FASB's attribution period. Of the comment letters received by FASB on the exposure draft as tabulated by Martens and Stevens, nearly 80% commented on this issue, with less than 2% agreeing with the proposal.[42] The vast majority of the comments agreed with the FEI that postretirement benefits should be attributed up to the date of expected retirement.

The cause for concern in the attribution period stems from how quickly the benefit obligation will accrue on the balance sheets. With a longer period to accrue costs, the impact on financial ratios will not be as significant. FASB's method forces preparers to acknowledge the obligation more quickly, and thus, is closer to providing readers with accurate financial information.

> In its redeliberation of the attribution period, the Board observed the results of the field test of the Exposure Draft. Those results suggested that, for many employers who elected delayed recognition of the transition obligation, the difference in net periodic cost that results from attributing the expected postretirement benefit obligation to an employee's full eligibility date rather than the employee's expected retirement date is minimal.[43]

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[42]Martens, op. cit., page 21.

[43]Statement No. 106, op. cit., paragraph 225.

Discount Rate

Related to the requirement for the assumption of the health care trend rate is the assumption of the discount rate for measuring present value of the postretirement benefit obligation. The Board concluded that selection of an assumed discount rate "should be based on discount rates inherent in current prices for settling the related obligation," similar to the assumed discount rates for pension measurements.[44] FASB stated obligations for some types of postretirement benefits can be settled by purchasing insurance or annuity contracts, although contracts generally were not available to cover all benefit costs. In the absence of ability to settle an accumulated postretirement obligation currently, the accounting standard requires current rates of high-quality fixed-income investments be used in calculations.[45] Each year, rates would be reevaluated based on whether the rates represent the best estimates of current settlements.

Opponents of the exposure draft disagreed with the discount rate approach. Less than 6% of the comment letters agreed with the FASB approach.[46] Two general objections were raised:

1. No settlement instrument exists that specifically covers the cost of retiree health care benefits; and

2. Funds used to pay postretirement benefit obligations are usually generated internally, not by investing in high-quality fixed-income investments. The letters offered a variety of

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[44]Ibid., paragraph 158.

[45]Ibid., paragraph 159.

[46]Martens, op. cit., page 23.

alternative approaches, with the most common approach using the company's internal cost of capital.

FASB would not permit employers basing discount rates on internal costs of capital because different employers would use different discount rates in measuring projected obligations. FASB stated their approach "should result in more comparable measures of the accumulated postretirement benefit obligations and of the service and interest cost components among employers."[47]

To measure the impact of using different discount rate approaches, the FERF field test illustrated the impact of companies' obligations and expense in the year of adoption using discount rates from 9 percent to 15 percent. Most companies used discount rates ranging from one to three percentage points higher than the discount rate selected based on guidance in the exposure draft. Appendix 2 illustrates the results of the testing.

The results show use of an alternative discount rate decreased the accumulated postretirement benefit obligation at the date of adoption by five percent to 42 percent and expense by three percent to 32 percent. Generally, the greater the discount rate was increased, the larger the difference was in the obligations and expenses.

FASB's requirement of basing the discount rate on the basis of the rates of high quality, fixed income investments should result in more comparable measures of obligations and expenses among employers.

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[47]Exposure Draft, op. cit., paragraph 160.

Amortization of the Transition Obligation or Asset

A fourth area of concern for many of those commenting on the exposure draft was the transition obligation. The transition obligation is the difference between the accumulated postretirement benefit obligation at the beginning of the first year in which the statement is applied, and the fair value of plan assets (transition asset if the fair value of plan assets exceed the APBO). Because very few companies fund their benefit obligations, the transition obligation will equal their total accumulated obligations.

The accounting standard requires companies to amortize transition obligations using a straight-line basis over the greater of the average remaining service lives of active plan participants, or over twenty years.[48] Other alternatives were considered by the Board, including immediate recognition of the obligation, which the Board believed "would most significantly improve financial reporting."[49] However, the Board recognized that the potential magnitude of the obligation (estimated to be at least $227 billion by the General Accounting Office, other estimates range as high as nearly $2 trillion by the House Select Committee on Aging[50]) required a more conservitive approach and prohibited immediate recognition of the entire transition obligation.

"The Board concluded that understandability and comparability of financial reporting, both in the year of adoption and in subsequent

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[48]Statement No 106, op cit., paragraph 112.

[49]Ibid, paragraph 225.

[50]Searfoss, D. Gerald and Naomi Erickson. "The Big Unfunded Liability: Postretirement Healthcare Benefits," Journal of Accountancy, November 1988. page 32

periods, would be improved by uniformly phasing in recognition of the transition obligation or asset for postretirement benefits for all employers."[51]

More than 53% of the comment letters received responded on whether immediate recognition should be permitted, and less than 2% agreed with the FASB[52]. Over one-fourth of the letters received proposed amortizing the transition obligation or asset over a period greater than 30 years. Additionally, 93% of the respondents believed that companies should have the option of treating transition obligations or assets as a change in accounting principle or as a prior-period adjustment. The effect of treating the transition obligation as a change in accounting principle would mean companies would have a one-time charge to income, while the effect of a prior period adjustment would have a one-time charge to retained 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 in the period of change." FASB denied this option in the exposure draft to enhance comparability between companies' financial statements. FASB later reversed their decision and now allows companies the option of taking a one-time charge against income. The Board noted that comparability would not be achieved by mandating that all companies immediately took the one time charge. Some companies had already switched to accrual accounting pursuant to Technical Bulletin 87-1 and others still had the opportunity to do so

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[51]Exposure Draft, op. cit., paragraph 227.

[52]Martens, op. cit., page 23

before SFAS No. 106 became effective. By allowing companies to have a one-time chance to recognize the transition obligations all at once, the effects would be consistent with other changes in accounting standards.[53]

CONCLUSIONS

Accounting for postretirement benefits other than pensions is complex. FASB has deveveloped an accounting procedure that is designed to change improve financial reporting. No longer will cash basis accounting be allowed. The following discussion will examine the extent to which SFAS No. 106 will be an accurate portrayal of employee benefit costs.

Will the Statement Work As Intended?

SFAS No. 106 will help to convey information concerning retiree benefits to users of financial statements. No longer will a financial statement reader have to wonder what size of liability exists. A liability will be recorded, so financial statements will become closer to an accurate picture of the financial status of a company.

The requirements of SFAS No. 106 will force financial statement preparers to gather information on potential obligations for retiree benefits. The newly gathered information will certainly aid management in decision-making regarding the benefit plans. Once the magnitude of the liability is acknowledged, some companies may even start to fund the obligations.

[53]Statement No. 106. Paragraph 265.

Will implementation of the requirements of the accounting standard give financial statement preparers the most accurate numbers of benefit obligation and expense? The answer to that question appears to be no.

The accounting standard requires a great number of assumptions. Projecting how fast health care costs will rise, or if new technological advancements will save costs in the future will be difficult for most financial statement preparers. The likelihood of two actuaries developing the same cost projections is small with the number of subjective judgments involved in the calculation.

The FERF field test found that preparers' best estimate of the rise in future health care costs was a range of 6.2% to 11.3%, based on requirements of the exposure draft.[54] Yet even a one-percentage point increase or decrease in the trend rate could change the accrued benefit obligation 13% and the expense up to 16%.[55] Differences of this magnitude point to the need for revisions in the accounting standard.

Statement No. 106 also relies too heavily on FASB's accounting for pensions statement for the process of determining the obligation. A computation of six separate components only complicates a calculation that begins with what some would call "unreliable numbers." Retiree benefit plans differ from pensions in that, most often, retiree benefits are not fixed on a defined benefit plan. Retiree benefit plans promise to provide services purchased at prevailing rates when needed.[56] The length of employee service does not have the same relationship to costs

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[54] Dankner, op. cit., page 101.

[55] Ibid. page 100.

[56] Gerboth, Dale L. "Don't Spit in the Wind: Nonpension Retiree Benefits," CPA Journal. September 1989. page 43.

as in defined benefit pension plans. Computing each year's service cost does not have the same meaning. In the case of the accounting standard, it is only an arbitrary allocation of cost.

Cost allocations, of course, are not objectionable when they have some basis in fact. But in the case of retiree benefits, there is no reason to use a calculation of six components that gives the appearance of more precision than is warranted. As one observer noted, "Anything suggesting precision in such an exercise is to be shunned."[57] FASB should instead find an alternative allocation method that would openly allocate the cost, avoiding all appearance of precision.

Does SFAS No. 106 Meet FASB's Objectives?

The Board's objectives in issuing Statement No. 106 were to improve financial reporting by:

1. Enhancing the relevance and representational faithfulness of reported results for retiree benefits;

2. Enhancing the user's ability to understand the extent and effects of employer's retiree benefit plans; and

3. Improving the understandability and comparability of amounts reported by employers.[58]

Although provisions in the accounting standard adequately deal with the relevance of information by requiring something to be recorded as a liability, the Board falls short in the other objectives. An

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[57]Ibid.

[58]"Proposed Statement of Financial Accounting Standards, Employers' Accounting for Postretirement Benefits Other Than Pensions." Financial Accounting Standards Board of the Financial Accounting Foundation. February 14, 1989. Summary.

involved calculation of components using subjective information that may not be reliable does not enhance the faithfulness of the outcome. The FERF field test has shown that companies will have a difficult, if not impossible task ahead in implementing the guidelines in the standard.

Will users of financial statements be in a position to understand and compare amounts reported? Financial statement users would definitely be better informed with the information required to be disclosed in the accounting standard as compared to past reporting guidelines; however; understandability and comparability would be greatly enhanced if much of the subjective criteria were eliminated from the calculation. By ignoring the potential inflationary effects of changes in medical technology or utilization rates years in the future and requiring more objective criteria for basing the calculations would give greater credibility to the numbers. Users would be able to compare results easier if there were fewer variables in the equation.

Financial statement preparers would also benefit by the elimination of the subjective criteria from the calculation. The cost savings in preparation time of financial statements would surely be great, and reliability of the numbers would not be impaired.

FASB has made significant progress toward improving reporting of retiree benefits. The Board should re-examine some of the components of the accounting standard to ensure that all of the objectives of the project will be met.

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APPENDICES

Appendix 1

Percentage Change from Exposure Draft Approach

	Exposure Draft Approach $Millions	Nonprojected Approach	Nonprojected/ Nondiscounted Approach	General Inflation Approach	Medical Inflation Approach
Assumed Trend Rate	7.9%	0%	0%	4.5%	6%
Assumed Discount Rate	9.25%	9.25%	0%	9.25%	9.25%
Highly Mature:					
APBO at Adoption	$98	(53.1%)	15.3%	(31.8%)	(21.0%)
Expense at Adoption	$16.2	(58.0%)	(45.0%)	(35.5%)	(23.2%)
Immature					
APBO at Adoption	$23	(64.9%)	21.8%	(41.0%)	(27.3%)
Expense at Adoption	$ 4.4	(68.9%)	(31.5%)	(43.0%)	(27.6%)

Danker, Harold, et al. "Retiree Health Benefits - Field Test of the FASB Proposal." Financial Executives Research Foundation. 1989. Page 104.

The table above shows the various alternative approaches to the health care cost trend rate that were reviewed during the field test of the exposure draft. Each of these approaches are described in more detail on pages 19-20 of the paper. Under each of the alternatives studied, the expense at year of adoption would be less than what the Exposure Draft had required.

Appendix 2

	Increase in Discount Rate from Exposure Draft Rate		
Decrease In:	Less Than Two Percentage Points	Two to Three Percentage Points	Greater Than Three Percentage Points
APBO at date of adoption	4.8 to 17.7%	25.1 to 34.3%	27.9 to 41.6%
Expense in year of adoption	2.8 to 14.5%	20.4 to 31.7%	16.9 to 29.6%

Danker, Harold, et al. "Retiree Health Benefits - Field Test of the FASB Proposal." Financial Executives Research Foundation. 1989. , page 109

The table above illustrates the impact of a company specific discount rate on obligations and expenses in the year of adoption of the statement. The results show the greater the change in the discount rate used from the guidance suggested by the Exposure Draft, the greater the impact on obligations and expenses.