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ACCOUNTING FOR NON-PENSION POST-RETIREMENT BENEFITS

Moderator: CRAIG A. OLNEY. Panelists: DOUGLAS J. CAREY, TIMOTHY S. LUCAS. Recorder: RONALD L. SEVCIK*

1. April 19, 1983 Discussion Memorandum - Employers' Accounting for Pensions and Other Postemployment Benefits.

2. Current FASB developments.

3. Funding issues.

4. Assumptions and methodology.

5. Other.

MR. CRAIG A. OLNEY: I would like to introduce my fellow panelists, both of whom are from Connecticut. Tim Lucas is with the FASB and Doug Carey is a partner with Hewitt Associates. At this particular session, we are going to concentrate on the discussion memorandum, and even more than that, we are going to concentrate solely on postretirement medical benefits.

At the end of this panel discussion, if we have time after the questions on health care have been asked, we will open up the panel to other items in the discussion memorandum, such as foreign plans, insured plans, defined contribution plans, etc.

As far as health care goes, it appears as though right now we are about in the same position as we were prior to APB Opinion No. 8 being issued for pensions. Most employers now are going along with a pay-as-you-go basis, and unfortunately, many may not realize what they have gotten themselves into. I would like to give one example that I have run into on the pension side. I was involved in a negotiation with a UAW local, and I was providing the negotiator with costs of various benefit increases. There was one benefit that he felt would have no cost, and so there was really no reason to ask the actuary about it. He ended up giving it to the union during the negotiation as kind of a goodwill gesture. Unfortunately, that little or no cost item happened to be a 30-and-Out provision providing unreduced retirement to employees after 30 years of service. He thought there would be no cost in the current contract period because nobody was even close to having 30 years of service. We opened his eyes a little bit when we did the next year's valuation and the costs went screaming upward.

I think the same thing is going on with postretirement health care. In fact, I know it is with some of my clients. We will go in for negotiations, and they will be fully aware of the health care cost per active and any changes that might occur there. But they have almost given away the

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postretirement health care coverage as a no-cost item because there are no retirees for four or five years. I think the actuaries have fallen down a little bit, as well as the accountants, in recognizing whether or not there is a liability for this coverage. That is the genesis, I believe, of the discussion memorandum we are going to discuss today.

My understanding of this discussion memorandum, specifically with regard to postretirement health care coverage, is that it is not a "thou shalt" type pronouncement from the FASB. They are not telling us how we are going to treat it. In fact, it is more of a cry in the wilderness asking us for help as to how to recognize this health care coverage liability.

First Tim will review the discussion memorandum on retirees' health care, the questions they are asking, and for that matter, whether it really is a liability or not. Then Doug will follow up with an actuary's view and give us some input as to the size of the liability that we are talking about.

MR. TIMOTHY S. LUCAS: I appreciate again the opportunity to be here and share our ideas with you at this entire meeting. I particularly appreciate the opportunity to devote this session to the other benefit subject. I think other benefits are a very important part of the Board's current pension and postretirement benefits project. In some people's eyes, it is the most important part of the project. This is really the first opportunity I have had to devote an entire time slot to this subject. Certainly, this is an area where the Board needs your help, at least as much as in the pensions project that we discussed yesterday. What I want to do today is give you a quick overview of the pieces of this project that relate to other postretirement benefits or other postemployment benefits. We sometimes use the acronym OPEB as a short form of that around the FASB. The overview will include the steps that we have already taken which date back to 1979 and also a few predictions about where we may be headed in the future.

Let me start by saying a little bit about what we mean by other post-employment benefits. One of the questions is, what do we mean by other postemployment benefits? Specifically, in the Preliminary Views document, we are addressing, as Craig said, postretirement health care benefits. We also include postretirement life insurance benefits or postretirement death benefits, which is a variation on the same thing. I want to highlight those steps of the pensions project that have involved the other benefits issue, which has been part of the project since it began.

In July of 1979, the Board issued an exposure draft on disclosure in employers' financial statements, and that exposure draft ultimately became Statement No. 36 requiring disclosure of several things in the footnotes of the employer's financial statements. The exposure draft that was issued in 1979 as part of that project included a small section that suggested certain disclosures on other postemployment benefits. It was limited to the existence of the benefits, the accounting method that was in use and the amount that was expensed under that accounting method. As Craig mentioned, all of the evidence we have indicates that almost everybody, there are a few exceptions, accounts for these benefits on a pay-as-you-go basis. Those of you who are familiar with Statement No. 36 know that there is no such provision in the final statement. The responses to the exposure draft were uniformly negative on the proposed disclosure of other benefits, and those responses suggested that the Board should consider this subject as part of the ongoing pension project because of similarities between types of benefits and because relatively little was known about other postemployment benefits. Relatively little is still known about other postemployment benefits, although perhaps we are making a little bit of progress.

The next step that involved other postemployment benefits was the 1981 discussion memorandum on employers' accounting for pensions and other postemployment benefits. It was issued in February of 1981, and issue No. 8, the last issue in that discussion memorandum, basically asked, "Should we accrue the cost of other postemployment benefits before the individuals retire?" The responses to that discussion memorandum at the public hearings held in July of 1981, and in the written responses that preceded them, generally agreed, at least in concept, that accrual of those benefits was appropriate. There were questions raised by respondents about the measurement or measurability of those benefits, and a number of people raised the question of whether these items were material. In fact, some asserted that they were very unlikely to be material in any case. I think the question of whether these benefits are material is fading a bit as we go along. We are hearing that less today, and I am sure that we will hear a little more information on that as we go forward today. The November, 1982 issuance of the Preliminary Views document included a segment on other postemployment benefits, and I will go over that in just a minute. The April, 1983 discussion memorandum included, in addition to a number of issues on pensions, four additional issues on other postemployment benefits, and I will address those in some detail in a minute also. Looking ahead, we are projecting or estimating an exposure draft on the pensions project in 1984 and a final statement, perhaps, by the end of 1985.

A number of the responses to date to the documents that are out for comment and in some of our contacts with people at meetings like this have raised the suggestion that at this point other postemployment benefits should probably be split off as a separate project. There is some concern, and I share it to some extent, that the important subject of other postemployment benefits accounting has been overshadowed in the controversy that has surrounded the Board's pension proposals. I think there is some justification for that. I am a little bit confused by the difference between the response to the original 1979 disclosure proposal and the response that we are now getting that says we should split it out. I am beginning to suspect that the Board may very well consider seriously that suggestion and may, in fact, create a separate project after the public hearings in January to consider other postemployment benefits as a subject separate from the pensions project. I think some of the people who have made that suggestion have either assumed or some of them have stated that they think the other postemployment benefits project should then be put on hold until pensions is finished. Then we can begin studying other benefits. I doubt that the Board is likely to do it that way. I suspect that if we make two projects out of them, we would see them proceed in parallel. Indeed, it seems possible to me that the other postemployment benefits project might result in a final statement before pensions rather than after.

The issue that was included in the 1981 discussion memorandum was quite straightforward in an accounting sense. It simply asked whether some kind of an accrual basis accounting was appropriate for these benefits. I want to raise the question briefly of why cash basis accounting, or something close to cash basis accounting, might be appropriate for health care benefits that are offered to active employees and might not be equally appropriate in the case of postretirement benefits.

I think one factor that bears on that is the difference in timing that is involved. The time between the service that is rendered and the subsequent payment of the benefit is likely to be fairly short in the case of an active employee, and of course, it is likely to be quite a bit longer in the case of a retiree. Another way to say the same thing, if we consider the accounting objective of matching costs that are incurred against the revenues that are produced, I think you can make a case that a cash basis accounting for active employees' benefits does a reasonable job of matching the costs and the revenues that are produced by an employee's service. The situation is quite different when you turn to retirees because the pay-as-you-go accounting which results in charging expense only in the period after retirement does not do a very good job of getting those expenses in the same period as the revenues that are generated.

Overall, the reasons for accruing other postemployment benefits are essentially the same as the reasons for making some kind of an accrual on pensions. If accounting is going to ignore significant costs, such as the cost of pensions or the cost of other benefits just because their payment is deferred, the resulting statements are likely to give false signals or likely to result in bad decisions. I think Craig highlighted a couple of those possibilities in his opening remarks. Those decisions that may be impacted include not only decisions made by investors who may be interested in buying or selling the company's stock, or creditors who may be making or not making loans to individual companies, but also decisions that are made on things like pricing the output of the services that are performed and decisions that are made in the area of what benefits to grant.

The Preliminary Views, which are the steps we have already taken, represent a tentative position of the Board on accounting for these benefits. Basically, the Board concluded that some form of accrual of the cost of postretirement benefits, particularly health care and life insurance, over the employees' working lives was appropriate. In other words, stating the same thing in a negative fashion, the pay-as-you-go or cash basis type of accounting or the terminal funding type of accounting, both of which are not allowed in accounting for pensions, are believed to be equally inappropriate in accounting for other postemployment benefits. That tentative conclusion of the Board involves a preliminary decision on the question of materiality. The evidence that we have so far, while it is not nearly as conclusive as we would like to have it and while we are seeking additional information, indicates that these benefits are material in at least some cases, and we have a growing body of evidence that they are extremely material in some cases.

I want to make a comparison now with an element of the pensions part of this project. As part of yesterday's discussion of the pension subject, I presented an overview of some of the foundations that underlie the Board's conclusions in the area of pensions. Those included: (1) the notion that the benefits are a form of compensation rather than something else, (2) the notion that cost of the benefits should be recognized in some fashion during the employee's working life, (3) the notion that the employer has an obligation for benefits that have already been earned, (4) in the case of pensions, the notion that the plan benefit formula provides evidence of benefits earned and is a basis for the accounting, and finally (5) the notion that the funding may very well be based on factors and methods different from the accounting.

Other than that, however, I think the Board's conclusion at this point is that the other foundations mentioned above apply to other benefits about the same way that they apply to pensions. That is, other benefits are a form of compensation, the cost should be recognized in some way over the employees' working lives, there is some form of an obligation to the extent that benefits have been earned and not yet provided for, and the funding question is a different one from the question of whether we should account for it. As in pensions, the Board is not going to take any kind of a position on whether these benefits ought to be funded, but we should recognize that some people may use the information that is provided in the financial statements in order to make funding decisions.

That is where the process so far has brought us to at this point. Looking ahead now, we have issued the 1983 discussion memorandum which includes several issues related to other postemployment benefits. First, and probably most important, the issue of measurement. How should the cost and the liability related to retirees' health care and life insurance benefits be measured? One aspect of that question relates to the feasibility of making any kind of a measurement or any kind of an estimate of these costs. I think that tentatively, at least, we are convinced we can make some kind of an estimate that will provide more meaningful information than the current estimate of zero. The other part of this question, and the one that is perhaps going to take us a little more time to get into, is the question of how far the Board ought to go in specifying some kind of measurement techniques to be used in measuring other postemployment benefits? I think it is important to step back at this point and say a little bit about the accounting process and how accounting progresses as new areas of it are explored.

One of the things I think I have learned over the last 4-5 years working with the FASB is that accounting evolves, rather than stepping forward to perfection in an individual area all in one step. Our goal in this and other areas is to improve the usefulness of the information. We recognize, and it is frequently brought back to us rather forcefully, that perfection is likely to always be out of reach, and where we can effect an improvement, that is usually the best we can do. I believe, and this is a personal opinion, that a financial accounting standard that requires accrual on a reasonable basis over the working lives of the participants of the cost of other postemployment benefits would be such an improvement in the evolutionary process of accounting for this kind of benefit. I believe that there is some possibility that that is about as far as the Board will go. You can think of that as being a statement, not unlike APB Opinion No. 8 in the pensions area. It would not involve the Board getting into the question of measurement. It would leave the question of how to do the accrual and what methods to apply to the individual accounting organization, to the accountants and CPA's, and to the actuaries. I stress that that is an individual view rather than something the Board has already decided on because this first issue is basically asking if the Board should specify more than just that there should be some kind of a reasonable accrual. Obviously, this issue is one on which we would very much like to have input from your profession.

The second issue that is included in the 1983 discussion memorandum is also very important, and it deals with the question of transition. Some people from industry have suggested to me that the transition in this area is much more important than the transition in the area of pensions. As in the pensions area, transition is essentially a pragmatic question. There are relatively few accounting concepts that guide us on how to move from one accounting standard to a different, and hopefully improved, apprach. One of the questions that we will need to deal with in the area of transition is the separation between the situation of active employees and retirees. It is not at all unlikely, in my opinion, that the Board would consider a solution that would accrue the cost of other postemployment benefits for current active employees over their remaining service lives, if you want to think of it that way, and that the Board, for transition purposes, would not mandate any catch-up adjustment relative to service that has already been rendered. That is made easier by the fact that you do not have a service connection or relationship to service written into the formula of the plan so that you do not have quite the same argument for recognition of a liability that exists in the pensions area. A related difference between pensions and other postemployment benefits is the fact that there is no vesting in most cases before retirement for these benefits.

On the retiree side, I do not want to outlaw or draw lines around any solutions to suggest that the Board will not consider just about any solution in the transition area, but I think the arguments are more difficult when it comes to retirees. I think the argument that says we ought to go ahead and accrue in some way the liabilities for benefits that have been promised to people who have already retired is more difficult to refute than the argument with regard to actives. That opens up a whole spectrum of different transition possibilities.

Some additional issues are included in the discussion memorandum. We are asking whether there are other types of postemployment benefits other than health insurance and life insurance or death benefits that ought to be considered. I know of none at this point. None of the responses that we have received to date have included any that I think are likely to be included as part of this project. There are some kind of interesting other benefits out there that raise questions of measurement, measurability, and so forth, that may be even more difficult than the health care. One that has been intriguing is the practice of some airlines to allow retirees to fly free as long as they live. You can imagine trying to value that one. My own guess is that we probably will not include anything in a final statement beyond health care and life insurance benefits, but I think this is a worthwhile time, or the appropriate time, to ask about the incidence of other benefits.

Finally, we had asked in the discussion memorandum for some ideas on what kind of information ought to be disclosed in the footnotes on other postemployment benefits. The disclosure question really cannot be answered very effectively until we have answered the question of what information we want to put in the basic statements, but this is also the appropriate time to be asking that question. In addition, a question that is included in the discussion memorandum seeks additional quantitative information about the incidence of and materiality of these benefits in particular cases. We have, or we think we have, a rather serious need for quantitative information to give us a better idea of what is involved in other postemployment benefits. To date, the request has not generated a whole lot of response. We are hopeful that that will pick up as time goes on. We would like to undertake some form of research, or additional exploration, of the quantitative aspects of these benefits. Several people at this meeting have asked me whether other benefits were included in the field tests or whether we were planning a field test in this area. Ultimately, down the road a piece, I think we may be able to do that, and I suspect that if we can do it, we will seriously consider it. At this point, we decided that a field test along the lines of the one that we have done in pensions is simply not practical because we do not have a sufficiently detailed proposal for the accounting to make the test meaningful. I understand that the Financial Executives Institute, through their Financial Executives Research Foundation, has begun the planning process for a project which is intended to give us some quantitative information about these benefits. We look forward to receiving that information and following it up. Any information that you have as the result of people looking into the incidence of this that can be shared with the Board would be very much appreciated and would be very helpful.

At this point, I am going to defer to Doug, and I will look forward to the question and answer session which is, as always, my favorite part of these sessions.

MR. DOUGLAS J. CAREY: As I was thinking about what I was going to say to you today, I thought of a number of possibilities. One was that I could stand up here for 20 minutes and give you my views of what the FASB ought or ought not to do in this area. I concluded, though, that that would be of only limited usefulness. But rather, since not as much is known about postretirement life and health benefits as is known about pensions, I thought I would spend the majority of the time talking about what is out there and what kind of financial obligations employers have incurred. I will save some time at the end for editorializing, however.

In terms of what is out there, of 659 major organizations whose benefit specifications we have summarized in Hewitt Associates SpecBook TM, all but 47 continued some benefits in the medical area after retirement. Of these 659 companies, 186 have continued dental plans as well as medical plans. Although the majority of them require some contributions from retirees, in many cases those contributions pay only a small fraction of the benefit costs.

What kind of levels are provided? They range from very small to very rich levels. We have tried to classify the plans by benefit level. A modest plan, representing about the 25th percentile in value, might be a continuation of the active medical plan for employees retiring before age 65 with limited Medicare supplement after that time. This very modest plan probably would not provide any dental coverage and would require heavy retiree contributions, especially for spouse coverage.

An average plan would continue a good medical plan to age 65, with the same plan continued after that with a Medicare carve-out. This average plan would still probably not provide any dental coverage and would require some retiree contributions.

On a very generous level, perhaps representing the 90th percentile in terms of value, would be, again, a continuation of a good medical plan to age 65 with a Medicare carve-out after that. This very generous benefit level would also include the provision of dental expenses and probably would not require any retiree contributions, even for spouse coverage.

Benefits in the death area are almost just as prevalent. Of these 659 companies, 550 of them continue some death benefits outside of the pension plan after retirement. The range of what is provided, again, varies quite a bit. On a very modest level it might be an ultimate death benefit of just $1,000 or $2,000 ranging to a rich level of perhaps a continuation of one times pay after retirement. Many companies reduce the level that is provided very rapidly after retirement in an effort to control the ultimate costs that are paid out. Of course, these benefits after retirement are much more valuable, as you all know, than before retirement because there is no question as to whether the benefit will be paid. The only question is when. This is also one area that many employers have taken steps to reduce benefits in recent years recognizing the relatively little perceived value that employees have for postretirement death benefits.

What kind of financial impact do these benefits have? As Tim mentioned, very few, if any companies today pre-expense for postretirement medical and postretirement life insurance benefits, the utilities perhaps being the major exception. Even fewer companies pre-fund these benefits. So today everything is on a pay-as-you-go basis. The annual cost per retiree may range anywhere from $500 to $1,500 or more, depending upon the level of benefit that is provided, as well as the retiree demographics.

What kind of cost increases could be anticipated if pre-accruing of benefits is required? Let's look at four key factors that would have a lot to do with the ultimate size of the cost increase. First, perhaps of primary importance, is the size of the retiree group. Obviously, the lower ratio of retirees to actives, then the larger the cost increase that can be anticipated. As an extreme example, if there are no retirees today, there is no cost for these benefits. But under a pre-expensing method, there would be a cost that would result. A more mature company, with the number of retirees equal to the number of actives, is already incurring a relatively large cost today, and thus, the cost increase by pre-expensing would not be nearly as large.

Secondly, and perhaps of equal importance, is the size of the benefit that is provided. I described three levels of coverages ranging from modest to generous. The generous coverage would require an expense that is about three times the level of the modest coverage, applied to an average group.

The next factor is an economic one and is also quite important. It is the health care inflation rate. If, for example, you assume that future medical costs are going to go up by 12% per year rather than 9% per year indefinitely, then that extra 3% would more than double costs. The final variable is the specific accounting method that is chosen which will have a lot do with the level of costs that result. If you apply the method that is suggested for pensions under the Preliminary Views, that would result in a cost that is 50% or more above the cost that might result under an Opinion 8 method. The difference arises primarily from a much shorter amortization period that would be required under a Preliminary Views approach.

The end result is that many companies will see significant increases in cost; it could easily be ten times more than what they are currently paying which, in some situations, may be 3% of payroll or more. I think, as Tim said, the issue of materiality has gone away.

Those of you who have analyzed these benefits have had to make certain actuarial assumptions and other estimates to get a handle on the measurement of these liabilities. In many ways, these assumptions are very similar to those that you have made in pension plan valuations, but they have a different impact in the measurement of postretirement medical benefits in particular, but also of life insurance benefits. Of perhaps key importance is when people retire. In a pension plan valuation it may suffice just to assume that the retirement age is 65 and not be terribly concerned about the financial impact to the extent that people retire other than at that age. In an analysis of a medical plan, the retirement age is of utmost importance because of the relatively larger liability that is incurred for people who retire before Medicare is available than is incurred after Medicare is available. Along a similar line is the termination assumption that you use. Again, unlike a pension plan where benefits are often vested after 10 years of service, in a plan of postretirement life or medical benefits, benefits are typically not vested and are only payable once a person reaches eligibility for early retirement age. Thus, those that are assumed to withdraw before becoming eligible would incur no cost, which makes this particular assumption also very important.

The two economic assumptions, the inflation rate that I mentioned and also the interest rate, are quite important in the determination of the liability. Unlike the pension plan, these plans typically have not been funded in the past. Many employers might choose to do so perhaps if they had a pre-expense, but some would not in the absence of any legislation to the contrary. So an interest rate assumption not so much represents the return on any invested plan assets as it does a discount for future liabilities, which perhaps is more akin to a corporate internal rate of return assumption. Also, the inflation assumption, if any is to be made, is quite important. As most of you know, health care costs have been increasing at 12% to 15% over the past few years, and thus, it would seem to be unrealistic in any projection of future liabilities not to include inflation at a similarly high rate. On the other hand, for any long period of time, if health care costs go up faster than the underlying interest rates, then ultimately through the miracles of compound interest, the health care sector becomes larger than the total GNP, which also seems to be an unreasonable conclusion.

As Tim identified, in trying to allocate this cost over different periods of service, we came up with a basic problem. There is not a nice accrual as there is in pensions. So any kind of service attribution is somewhat artificial. In particular, using a benefit approach, as the FASB calls it, or what we would consider to be a unit credit method, produces a somewhat artificial allocation to service. Perhaps even more important than that, if inflation and medical costs assumed are higher than the underlying interest rate, the unit credit method may produce a declining series of costs over time. That is, the age 25 year old person will have a cost in his first year of employment that is higher than a subsequent year's cost.

In analyzing these liabilities and thinking about potential future obligations that are out there, a small number of employers have taken some steps to try to limit the open-ended promise. One example was a major Fortune 500 company that has basically provided medical benefits at the average level that I described earlier. But rather than providing it in terms of an open-ended commitment, they provided a specific dollar schedule that is intended to pick up where Medicare leaves off. That has given this employer two advantages that I think are important.

One, those medical costs do not go up automatically with inflation, only by management decision. But perhaps more importantly, if Congress goes one step further and legislates that Medicare should be the secondary payor of benefits for retirees over 65 as well as actives over 65, this particular employer is in a much better position to limit his liability under that approach than would be many others. Another kind of tactic that some have used is to express what employees will pay, not as a specific dollar amount, but as a percentage of the costs that will be incurred, such as 40% or 50% of future medical costs. That builds the expectation among employees that their contributions will go up from year to year and also limits the promise that the employer had made to pick up these cost increases in the future.

I said I was going to spend a little bit of time at the end giving my opinion as to what the FASB ought to do in this area. I think there is a substantial opportunity, as Tim just identified, to influence their direction in what they ought to do and ought not to do. Let me give you some of my views which I emphasize are really my own views.

Are these benefits deferred compensation? In a final analysis, I would have to conclude they are deferred compensation. In a negotiated plan they are provided in lieu of wages. Certainly the benefits are not gratuitous. Companies do not give them to just anybody, they only give them to former employees. Can the benefits be stopped? Some have argued that because the employer has the ability to stop these benefits at will, then that by itself is an argument not to pre-expense those benefits. For retirees where a specific promise has been made, often in terms of a written plan description, I think it would be difficult, at best, to stop the benefits. I would guess that if an employer tried to do that, he would not do it without at least incurring some sort of lawsuit claiming the taking away of a contractual commitment that has been made prior to retirement. For active employees, perhaps the situation is a bit better. That is going to depend to some extent on what the employer has specifically promised. But again, I think that the employer would not do so without suffering at least some adverse consequences.

The accounting profession contends, though, that benefits and anything else should be accounted for based upon the going concern concept. Certainly, if the employer has the intention to continue these benefits after retirement, then I think there is a good argument that you have to accrue those benefits as well. Where I would disagree with the FASB is perhaps on their second fundamental - that is, for each employee the cost needs to be accrued during his own working lifetime. These benefits, as well as pension benefits, are much more of a group compensation exchange rather than an individual one. If an employer were making a decision individual by individual, there is no way he would decide to grant an age 50 year old who is going to retire in five years medical benefits forever when that might cost 50% of that individual's pay. On the other hand, the cost for a 25 year old, who has perhaps 30 or more years to retirement, would only be a small fraction as a percent of pay. It is only by weighting those to costs that the employer would decide that it is a reasonable benefit to grant. Therefore, I think that the expense does not need to be accrued over each employee's working lifetime but rather over a reasonable period that might represent the working lifetime of the employees as a group. This perhaps provides an argument for not accruing the entire cost of retirees' benefits thus far granted as part of the transitional requirements.

In terms of the specific accounting for these benefits, although I would agree that some accrual needs to be made, and employers, in fact, are fooling themselves if they think the answer is zero, I also would agree that no single approach is appropriate in all situations. What is going to work for a large industrialized company with a large number of retirees is not going to work as well for a company that has just a very few retirees, perhaps a computer company. One single method, I do not believe, will provide a reasonable allocation of costs among generations of stockholders in each situation. But rather, the method needs to be more tailored to the specifics of the situation with an objective of accruing costs perhaps uniformly as a percent of pay, as an example.

Beyond that, I must admit I am somewhat concerned about the inflation issue and the necessity to anticipate future inflation in medical plan costs. Should management today be paying for future inflation? Should balance sheets today reflect future inflation when on the income side they certainly do not reflect future inflation in prices and other expenses, and they do not reflect future inflation in salaries and other kinds of benefits. I am somewhat concerned that in this very current value accounting for these benefits, if, in fact, a future inflation rate is used, might produce an inconsistency and a distortion when other income and expense items are handled on a more historical cost basis.

There is, however, one inescapable conclusion from the FASB's proposal in this area. That is, it has made many people more aware of what they have granted. Many companies have no idea what kind of liabilities are out there and are just beginning to study them. Many a senior financial officer has been surprised at the magnitude of liabilities that have been promised. In some cases it is significantly greater than the pension liabilities. They are just now beginning to step up to the table and decide what kind of action, if any, they can take to curtail or eliminate the future liability commitment. In many cases, that is difficult because these benefits have been granted in the past very freely without a recognition as to the liability and the costs that they have been incurring.

MR. OLNEY: I would have to concur with Doug on the materiality of this item. We have performed a couple of studies on the magnitude of the liability of heatlh care coverage for just retirees. We blew the socks off the financial officers that were looking at this study. The difficulty in a study such as this is determining the inflation utilization of medical care and the discount rate that you use. Also of primary importance is the retirement age. A company with 30-and-out pensions had retirees, age 49-50, who had 15 years before becoming eligible for Medicare coverage. They had dependent spouses who were in the lower 40's and would not become eligible for Medicare coverage for 25 years and, in some instances, had children that were covered under the postretirement medical care coverage.

Now I would like to open up the session to questions for any of the panelists. I would like to stick to the postretirement health care coverage first. Then, should there be no further questions and we have some time available, we will take questions on anything else in the discussion memorandum. Are there any questions?

MR. MURRAY BECKER: I would like to ask Tim Lucas what accounting justification can there be for focusing on benefits which are part of compensation and saying that we should accrue future inflation in that area and charge it to current operations while the main compensation expense, salary, does not do that. And if it is correct for one, why shouldn't we actuaries be doing the present value of future salaries and charging some of that to current operations and past operations?

MR. LUCAS: The accounting question is really one of trying to measure or quantify the amount of a promise that has already been made. That dividing line between promises that we have already made and promises that we expect to make in the future is one that presents difficulty in a number of areas, but it is paramount in pensions and other benefits right now. What we have, particularly in the area of other benefits, is essentially an indexed promise. We have made a promise to provide certain benefits, and the amount that we will ultimately pay for the promise that we already have made is uncertain because it is, in effect, indexed. It is a function of a future price. Those situations in which companies are willing to undertake indexed promises are relatively rare and that is why, for example, the salary question is different from the question of other benefits. If we look at next year's salary, we really have not yet promised to pay an employee next year's salary. In an accounting sense, that obligation will be incurred as next year's work takes place. So the accounting question we come down to, which is similar in pensions and other benefits, is trying to define the promise that has been made in return for past service or this year's service. To the extent that the promise is indexed or is a function of future promises, then at least a good case can be made for reporting it on that basis. I think if we had other situations where services or goods were received today, and the contracts to pay for those were such that they were a function of a future price, accountants would very likely consider accounting for the expected inflation in that price.

The other thing that we need to think about a little bit is the relationship between the future inflation question and the fact that this is essentially a discounted obligation that we are proposing to record. The question of whether the obligation for postretirement health care, for example, should be recorded on a discounted basis, as opposed to simply recording the raw dollar amounts that we expect to pay this person in the future, is one that we discussed and decided we really did not need to stress in the discussion memorandum. No one, to my knowledge, has come forward suggesting that discounting is inappropriate for this particular obligation. Obviously, if you did not discount the amounts that were to be paid over an individual's life, you would get a rather more material and significant number in all cases, or almost all cases. Although, as was mentioned earlier, where you have an inflation factor that is greater than a discount rate, the power of compound interest tends to work against you rather than for you. So I think if we were going to try and take the inflation out, we would have to take a long hard look at whether we were going to discount the obligation and at what rate.

MR. CAREY: Tim, doesn't it produce an inconsistency, though, to recognize future inflation as an expense item and not recognize it in future prices of assets or inventory, for example?

MR. LUCAS: Not in my mind. If we have acquired an asset, a piece of machinery or something, and we have agreed to pay for it ten years hence and to pay ten years hence the price that is current at that time, then I think we would have to consider accounting for the price we have agreed to pay. But we do not acquire machinery that way. That is the fundamental difference.

MR. CAREY: I guess I am focusing on the asset side. If you have certain goods in inventory that perhaps provide several years of sales, as an extreme situation, and these goods are expected to be sold at prices that are higher than they are today, in valuing these goods you certainly do not discount the expected price that you are going to get. You value them more on an historical cost basis. Isn't this applying a different standard to the liability side of the balance sheet than is being applied to the asset side of the balance sheet?

MR. LUCAS: I do not think so. When you look at the assets like inventory, we are really not talking about discounting what we expect to get for selling this. Accounting practice has been to report essentially what we paid for them, and now you get into the confusion of whether you want to use FIFO or LIFO, different schemes for figuring out how much you paid for the individual units you have left in inventory. However, the focus has been on recognizing what we paid for them rather than trying to discount what we expect to sell them for, but that is really a very different question from how do we recognize obligations, especially those that are indexed.

MR. ROBERT BEIN: Just a follow-up point on the inflation. Tim, do you think it is inconsistent to recognize the future inflation rates in coming up with the present value of future life insurance benefits, for example, because we are projecting a salary and, therefore, projecting a life insurance benefit after retirement, and then not relate that present value of a future death benefit to present value of future compensation to come up with a current cost?

MR. LUCAS: So far, the Board has had no discussion of what kinds of allocation approaches are to be used to spread the expected costs of the benefit over the working life, which I think is what your question relates to. If we go forward on the basis of saying we need to accrue this on a reasonable, rational basis and the Board is not going to say anything, at least at this point, on how to do that measurement, then that would certainly not be precluded. It does not seem totally inappropriate to me.

MR. BEIN: Hasn't the Board taken that position with respect to pensions?

MR. LUCAS: The position with respect to pensions was that the allocation should be based on years of service. There was some sentiment for a salary base allocation as opposed to years of service. I think the factor that caused the Board to reject that was the fact that that particular allocation method is not one of the ones that is allowable for regulatory purposes. While we continue to believe that funding and accounting should be different, where we had a close choice between two accounting approaches, either of which could be supported, we were reluctant to choose the only one that is not allowed for the other purposes.

MR. BEIN: Sounds like there is a need for some consistency there.

MR. LUCAS. Well, I feel fairly sure that if the Board were to discuss or address the measurement question on other benefits, the actuarial cost method, if you will, that should be used, if we limited that, we would be unlikely to limit it excluding the method that was allowed for pensions, one form of limited consistency.

Let me ask Doug Carey a question, if I may. Doug, you said at one point that you would not favor a single approach, and I have said that I am not at all sure the Board would either. But in justifying that, you said that what works for a large industrial company may work for a young computer company or a computer company with a young population. My question is, how do you define what works? What is the characteristic of "works" that underlies that statement other than the need to produce a number that can be afforded in the sense of funding?

MR. CAREY: I think that for this kind of a benefit that does not accrue by service as does a pension benefit, the goal should be to accrue cost. If you are promising the same benefits year after year, then it would seem as though it ought to be a somewhat level percent of payroll cost. There are not, perhaps, the same kind of immediate gains or losses to recognize since you may not be funding this plan at all. There may be little measurement problems, but I would hope that those could be smoothed out to the greatest extent possible with the result that if this benefit really costs 3% of payroll, then in my mind, it makes sense to spend 3% of payroll.

MR. LUCAS: Why wouldn't the same method, though, work for those two companies?

MR. CAREY: Well, I am not sure that any single method will produce the desired result in all instances. As an example, and I will get back to pensions because that is an area that I am more familiar with, if you start up with a new pension plan, and you decide that your objective is to keep cost level as a percent of pay under the particular accounting approach, then entry age normally may be a perfectly reasonable method because the entry age cost will stay level as a percent of pay with little, if any, past service costs. On the other hand, if you put in a pension plan with a large amount of past service benefits that you have granted, then your cost under that plan is not only the normal cost, but a dollar amortization of the past service cost that can perhaps decline as a percent of payroll. So, for that second case, where costs decline as a percent of payroll, perhaps another method would make more sense with the objective of keeping costs level as a percent of payroll. I am not sure exactly how this example would translate to the postretirement side, but I think the analogy is appropriate.

MR. FRANK FINKENBERG: With respect to Medicare carve-out plans, there is an assumption, frequently implicit, which is perhaps equally as important as the inflation assumption, and that is the percentage of total medical costs that will be born by Medicare or another public plan. Historically, I think the percentage of costs born by Medicare has been decreasing. What I do in most situations is to project the present ratio of costs born by Medicare into the future. That may not be a good assumption, but it is easy. It would be possible to project a continued decline, or it would also be possible to say that before we reached a situation that was referred to of the medical care costs exceeding the GNP, you might have a totally nationalized health care system so that we might project a very limited role for the private sector for future retirees. I would like to ask the panel and other attendees how they are addressing this frequently implicit assumption.

MR. CAREY: I do not pretend that anything I have said was so precise as to specifically define that, although I think I would agree with you that in the studies we have done we have assumed that Medicare is going to continue to replace a constant percent. I think you have raised a valid point though. That certainly is a question that Congress could easily change, and costs could go up much greater than they have.

MR. LUCAS: I do not think I really want to address that one at all except to say that I think that is one of the reasons the Board ought to stay away from the measurement questions in this area to the extent that it can.

MR. OLNEY: In the studies we have performed, rather than getting a specific set of assumptions as in a pension plan, we have gone best case, worst case, most probable case, and tried to put bounds on the liabilities rather than coming down on a specific assumption. Although this would be a statistical approach, I am not sure how this would affect the accounting for it, since I doubt you could put in three numbers for the same liability.

MR. LESLIE LOHMANN: It seems that there is some desirability of expressing the costs of doing business as a fairly constant percentage of the price that one gets on the output. We strayed rather dramatically away from that on the pension side, and I for one would like to see us stick as close as possible to it on the other postemployment benefits question. It seems that where there is no formula to base an accrual of other postemployment benefits, a projected benefit method or cost accrual method would be the most appropriate method, especially one which allocated that cost as a percentage of salary which usually can be expressed fairly nicely as a percentage of the cost of output. If we stray from percentage of salary allocations, we are going to find ourselves getting deeper and deeper into this funny asset/liability balancing mode that we are currently in on the pension side.

MR. LUCAS: I think the desire to keep costs as a level percentage of the sales proceeds or the proceeds of selling the output might be more appropriately attributed to the management of the business than to say that that is an accounting objective. The objective of accounting is to measure the costs that are incurred, rather than to have a pre-ordained result that says cost should be a level percentage of sales. This is great if it comes out that way, but we are supposed to be measuring whether it turns out that way, not designating that that is implicit or inherent in the system that we have set up. Where you have a cost that is incurred in an undefinable way or in a way over a period of time that is not precisely determinable, accounting frequently reverts to use of what we call an allocation, and in that case, it is typical to allocate something on what is called a systematic and rational basis, and a level percentage of output would qualify for that.

MR. LOHMANN: I appreciate that point, but at the same time, from the life insurance company side, that principle was one of the major motivating forces on the whole GAAP expensing the deferred premium policy question cost element, and again, I would like to look for some consistency.

MR. CAREY: I agree with Mr. Lohmann. If there are not any real changes from year to year, I find it hard to understand why the costs should change year to year just because of measurement technique. In the absence of changes in the benefits that you have provided or else your assumptions being just grossly off, I do not understand why the relatively same cost cannot be accrued from year to year. I think that it would provide the objective that the accounting profession is looking for in accruing these costs during the employee's working lifetime without introducing the volatility that measurement changes are perhaps likely to introduce.

MR. LESLIE STRASSBERG: Has any thought been given to the ramifications of the FASB position here on a collective bargaining process. As you know, contributions to collectively bargained health and welfare funds are set at the bargaining table, and the FASB's insistence on employer liability in this area would have some interference with this process, especially if federal legislation would be enacted requiring advanced funding of these obligations. So my questions is whether any thought has been given to the 30 or so million employees in the United States covered by collectively bargained health and welfare funds.

MR. LUCAS: We have considered and discussed the potential impact of an accounting change on collective bargaining in a general sense. We are convinced that recognizing costs that have really been incurred will be beneficial overall and that the Board would be straying from its mandate if it essentially accepted an argument that says we ought to hide these costs because if we have to report them, it will change the decisions that people are making. I think that applies perhaps in this area even more than it does in pensions, just because the accounting in this area may be further from something realistic than in pensions.

MR. GAYLEN LARSON*: I just want to make a comment. The question on life insurance - Tim did not really respond to that, but I think the point is that what you are trying to measure there is the profitability of a life insurance product over the period that the risk is occurring, and I think it is a different accounting issue than the subject of today's discussions. So I do not really see the relevance personally.

MR. OLNEY: One question I would like to ask Doug. We were talking about materiality, and I believe Hewitt Associates has done a study on liability for retirees as a cost per active employee. Possibly you could share a couple of the numbers with us.

MR. CAREY: I would be happy to. As Craig mentioned, we have just completed a study based upon an average situation. For example, if you assume that health care information is 9% annually and use a 9% discount rate which, as you all know, makes the work very easy to do, and you also take into account the average benefit levels identified earlier as being the 50th percentile and you have demongraphics of one retiree for every seven actives, you are currently paying about $1,000 per retiree, which translates into $140 per active employee for this plan. On an Opinion 8 type basis, it could easily result in costs in the thousand dollar bracket level, which is about seven or eight times what it is currently. Preliminary Views methodology yields costs substantially higher than that. Increasing the inflation rate by 3% to 12% typically would double the accrual costs. Obviously, it does not have any effect on the pay-as-you-go costs immediately. Also, decreasing the number of actives per retiree increases the costs much more on a pay-as-you-go basis than an accrued basis because you are taking the same cost and spreading it over a fewer number of people.

*Mr. Larson, not a member of the Society, is Group Vice President and Controller of Household International in Prospect Heights, Illinois.

MR. BECKER: A question for Mr. Carey. What would you want to do with respect to future deductibles in a carve-out plan? It seems to be unreasonable to assume lots of inflation with an employer deductible not being increased at some point.

MR. CAREY: Well, I think you have the same problem there that you have in any kind of specific dollar promise. That is the same problem that you have, although of an opposite nature, in a dollar times service pension plan. Maybe Tim had better address that, but I think that if you promise the employee that you are going to pay all benefits in excess of $100, and that is a specific written promise, I would find it hard to argue that you ought to build the cost based upon an automatic escalation of that deductible. An automatic escalation of a deductible would be a decline in the promise.

MR. MICHAEL SYDLASKE: I have questions for both Mr. Carey and Mr. Lucas. First, on the projection of costs, I think our firm in New York now is getting towards projecting increases for everyone that go up with age as well as secular trends. In other words, somebody age 62 this year will have his cost go up by whatever age produces for him as well as secular trends. So 9% interest, 9% secular trend would still be a hard calculation to do in a way. I think following up on Murray's question, the whole retiree medical issue gets much more complicated if we do not have a written plan, and it seems to be very complicated to say that we are going to assume or we are not going to assume that deductibles are going to increase and co-insurance is going to stay the same. We are also not going to believe an employer if he tells us that he only covers people who retired before 1987. And a third employer perhaps has a policy that he is going to charge retirees for the cost of medical coverage beginning in 1988. There are a lot of pseudo-plan provisions an employer can put into a retiree medical plan with little or no regulations and little or no way to keep track of just whether he is going to do it or not, and I think that is a question of just what do we value when we go to value a medical plan?

MR. CAREY: If the employer's intention is to increase benefits, I guess in my heart I feel that you ought to build that in. On the other hand, there is the issue as to just what is the specific promise. As an example, if benefits are defined in terms of specific dollar amounts or employee contributions are defined as a specific percent of cost, I think there is good justification for taking those limitations into account. When management increases the benefits, then there is a cost increase associated with that benefit increase that is incurred at that time.

MR. LUCAS: What you are really getting at is a much broader question, trying to separate the substance of an obligation from the legal form of a piece of paper that documents it. That is always a difficult area. There is nothing unique about that in this case. Maybe it is more difficult because of the complexity involved and because perhaps the materiality that creates greater incentives to do that sort of thing. Certainly we have the same kind of suggestions in the pensions area, where it is suggested that, for example, people will put together a plan that is going to cover salaries, but only salaries up through 1987, and in 1986 they move that to 1990, and so forth. There are a lot of those schemes that can be put together. Schemes, incidentally, is the English word for pension plan, and there is no derogatory connotation.

In concept, the accounting would like to follow the substance of the obligation rather than its form. In practice, our ability to do that is somewhat limited. Where the form and the substance are very different, we are likely to have some accounting problems. Some of the things that we might suggest would be additional disclosures, in terms of what are the terms of the plan, so that the user who is going to study it in detail can figure out what is happening, and in my mind at least, it would also suggest a relatively rapid amortization of the cost of the plan changes so that in the year when they do make the change, we have a relatively rapid reflection of that change in the statements, but there is no simple overriding all-curing answer to that problem.

MR. BECKER: Just a response to your comment. The employer in his plan is really not saying I am going to pay 100% of the expenses in excess of $100. What the employer is saying if you are retired is that we will pay the difference between our plan for active employees and what Medicare reimburses. Right now, most of our clients are intensively reviewing their plan for active employees, and there seems to be a strong movement towards raising deductibles and doing other cost containing features. One would think that if we are going to be projecting any degree of significant information, the trend which already exists in active plans would be continued and not pay what the present plan now says, but to pay the difference between the active employees and retired employees.

MR. CAREY: I would think that an employer that expresses a promise that way would be in a much better position to do that than to express it in terms of a dollar amount.

MR. BEIN: Mr. Lucas, on the same point, what reaction do you have to an approach that would cause the employer to recognize the current proportionate share of medical plan costs for a postretirement death benefit cost as the thing that we will project into the future. That is, that we will always keep the same proportionate employer cost as we move all the costs added to the future.

MR. LUCAS: Employer cost proportionate to what?

MR. BEIN: To the total cost. So if the employer is now paying 60% of the total cost of the plan because, in the case of a medical plan, there are certain deductibles and co-insurance features, we would implicitly expect the employer to maintain that level sharing of cost. What do you think of that approach?

MR. LUCAS: Would the plan be written in such a way that the terms would say something other than we are going to pay 60%? If the plan terms say we are going to pay 60%, then that is exactly what I would project.

MR. BEIN: No, I would think that we would have to rely on substance rather than the form to follow your comment.

MR. LUCAS: At this stage, at least in the other benefits area, I would not be at all surprised if the final standard would allow some room for relying on the substance over the form, recognizing that on some occasions when we have done that, we have gotten some strange substances and that has led to pressure for more carefully defined requirements.

MR. SYDLASKE: I have a question for Bob Bein. I have a client that has an unwritten policy that he will pay 2/3 of the cost, but he has never done it yet. He is always aiming at paying 2/3, but he seems to be paying 75% to 85% of the cost year by year, and he hopes one day to get down to 2/3.

MR. BEIN: I think my response is that the substance of that client is that he pays 75%.

MR. CHARLES WALLS: Picking up Murray's very first question, there are several places where there are promises of future salaries and cost-of-living, for instance. Leaving aside the question of materiality, would these be thought to be subject of maybe leveling out in some fashion? For instance, contracts where you have written into a labor contract a 2%, 3% or 4% annual rise in wages and a cost-of-living of a few cents for a percentage increase in the cost-of-living index.

MR. LUCAS: Generally, they are not leveled. Generally, they are looked at as a method of determining the salary level or wage level for each particular year as it comes up. If, on the other hand, and this would be an unusual contract and that is why it does not come up in an accounting context, you have a labor contract that ran for five years and it specified that at the end of the five years, the salaries for all five years were going to be retroactively adjusted to be a certain percentage of the sales price of whatever they are selling, or to some other indexed amount. In that situation, which I have not encountered in practice, I would think that the salary for the first year would best be recorded based on an estimate of what that index was going to show. In other words, based on an estimate of what you are ultimately going to pay, under the terms of the contract for the salary in year one. It is the retroactive catch-up notion that really differentiates some of these index contracts from the kind of contracts you mentioned.

MR. WALLS: Well, that could be true in some bonus arrangements, and you would wish to account for bonuses that were deferred for some period of time.

MR. LUCAS: General practice would be to attempt to account for those as they are earned.

MR. OLNEY: I would like to close this session by saying apparently there is something out there that is not trivial. Postretirement medical costs appear to be material to almost all employers. However, the measurement of this animal, whatever the size of it, is going to give us actuaries some difficulty in coming up with reasonable assumptions. I would like to thank the panelists for their views and the audience for their good questions.