RECORD OF SOCIETY OF ACTUARIES
1990 VOL. 16 NO. 4B

POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

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- The soon to be Accounting Standard
  - Data considerations
  - Assumptions
    - Health care costs trend rate
    - Discount rate
    - Other
  - Anticipating certain plan changes
  - Attribution
  - Transition provisions
- The financial impact on companies
  - Will prefunding become worthwhile?
    - Taxes
    - Guarantees
  - Book reserves
  - Net worth
  - Stock and bond prices
  - Secured debt

MR. STEPHEN A. MESKIN: You may have seen a recent article in *The New York Times* that the Federal Accounting Standards Board (FASB) was having trouble recruiting Board members because the salary was only $72,500 -- per quarter. So, you will understand my feelings when I received a call later that day from FASB. I thought about it for a few minutes, and as soon as I got on the phone, I told Diana Scott I couldn't possibly accept a position at this time. She said she was disappointed but that the reason for her call was that she couldn't make it to this meeting because the Board, which we all expected to have resolved their problems with the subject of this session, was still debating a crucial issue. Needless to say, I was disappointed -- for two reasons. However, as you may have noticed, she has sent a very able colleague to pinch hit.

Postretirement benefits have been the subject of many sessions at these meetings for the last few years. As a consequence, we, the panel, will assume a general basic familiarity with the FASB exposure draft.

Before the end of December, the FASB plans to issue its final accounting standard for postretirement benefits other than pensions, sometimes called OPBs. The OPBs are

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primarily retiree health and death benefits. FASB issued its exposure draft, "Employers Accounting for Postretirement Benefits Other Than Pensions," in February 1989. Public hearings on the exposure draft were held last fall. Since the hearing, FASB has met more than 20 times -- by now it's probably more than 25 times -- to review the proposed accounting standard. Along the way, FASB has reconfirmed much of what was originally exposed in the draft. However, FASB has also made many changes, some of which are significant for actuaries. These actions are all tentative and could be changed again before the final standard is released later this year.

The basic premise of the accounting standard is that the cost of retiree benefits should be accounted for, that is, recognized and accrued while an employee is working and producing the income to pay for them. Currently, most employers account for the benefits when the retiree uses them. Recognition and accrual, however, are not funding in the traditional actuarial sense. Amounts recognized need not be placed in a separate fund for the benefit of retirees. However, any costs that are recognized but not funded must still be deducted from profits and then carried on the balance sheet as a liability.

The exposure drafted mandated that there would be a single method for measuring cost. The measurement would use explicit actuarial assumptions based on the best estimate of the future. A number of items would have to be disclosed per the exposure draft, such as funded status, plan descriptions, assumed discount rate, assumed health care trend rate, and the effect of changes in the trend assumption. The original exposure draft also included the mandate that there would be an additional liability called the minimum liability added to the balance sheet after a number of years if the accrued liability was not large enough.

Our first speaker, Wayne Upton, will describe the tentative changes that FASB has made to the proposed standard. Wayne is a CPA with over 20 years' experience. He is a project manager at FASB on a project dealing with discount rates. He has been with FASB for six and a half years. Some of you may remember him as the project manager on FAS 97.

MR. WAYNE UPTON: I am standing in for Diana. I am a consultant on the post-retirement benefits projects. All of our projects at the Board have both a lead project manager and one or more colleagues who serve in a consulting capacity, and one of the things that a consultant does is when the Board overruns their schedule of meetings and continues to deliberate an issue, the consultant, like a good chief cook and bottle washer, fills in.

I need to open up with a disclaimer, that being that the Board encourages the expression of views by members of the Board and the staff but that much of what you'll hear are my own opinions. Official positions of the FASB on matters of accounting are reached only after extensive deliberation and due process. That's the $5 disclaimer. The 50 cent disclaimer is that if I should offend anyone, and experience proves that I do have a certain proclivity for that, please accept it as a personal insult. Were the FASB to insult you in an official capacity, we would have to issue an exposure draft, schedule a hearing, and redeliberate all of the issues before reaching a final conclusion.

As Steve mentioned, I'm going to assume that most of you have a basic, working understanding of what was in the exposure draft on OPB, and I'm going to focus on the significant changes that the Board has made to the document. I think it's important to understand that we almost always make significant changes. There have been situations in which the Board has reversed its opinion. That's not going to be the case here, but the Board has made a number of significant changes in the document in response to the comments that we've received. We received well in excess of 500 comments, held five days of public hearings, and have held a whole series of meetings with groups, including representatives of the Academy, since the issuance of the exposure draft to better understand people's views and to better understand some of the implications and perhaps unintended consequences that may have come out of the exposure draft.

With all that groundwork, I'd like to focus on six or eight significant changes. Perhaps the most significant is that the basis of accounting in the exposure draft was the written plan document as it stands as of the date of measure. The Board has now moved from that to a creature we call the substantive plan, and that is a very significant change. The change was occasioned by comments from a number of people in what we call the preparer community. Financial statement preparers suggested that a strict focus on the written plan ignored long history that many companies had, so where the exposure draft would say, for example, that an indexed plan in the measurement should assume a continuation of indexing, a similar company without an indexed plan but which had adjusted employee and retiree contributions every year for the last 20 years would have gotten a different accounting treatment. That did not seem to the Board to be equitable. A long-established practice of adjusting from year to year ought to carry the same weight of evidence in making the measurement as a plan that was explicitly indexed. Further, if you take the analysis a little farther, we are requiring that people anticipate the health care cost trend rate. Now, that's not a particularly radical assumption to a group like this. It's not different than being in the property casualty business and anticipating social inflation or changes in the cost of settling claims. It seemed inappropriate to the Board to say to a company, "You will, in making your measurement, estimate the effects of inflation," and then to say, on the other hand, "But you will pretend that you'll take no steps to deal with that problem." Again, that seems to be an inequitable approach to the measurement.

Well, what does a substantive plan do? The substantive plan language in the final statement will focus on the notion that a consistent practice of either increasing or decreasing, and I recognize not many people are decreasing retiree contributions these days, active and retiree participation through cost sharing, or other similar provisions, may indicate that there is a substantive plan that overrides or supplements the written plan document.

The anticipated changes in employee cost sharing have to meet several hurdles, though. First, the anticipated change has to be feasible. These are going to be judgment calls, and certainly feasible is a big one. Is it feasible for me to triple the retiree cost sharing? Notionally, perhaps, it might be. As a practical or economic matter, probably not. These are going to be issues that management, auditors and actuaries are going to have to wrestle. Second, it has to be likely. The proposed change has to be something that, in fact, management anticipates doing. We're talking here about staying away from a

wish list. And, finally, and this is the most critical requirement for many in management, it has to be communicated to the employees in some fashion. We cannot base a measurement on what management would like to do. We have to base a measurement on what management has communicated to the employees.

Why do we place so much emphasis on that idea of communication? It seems like such a pro forma step. For two reasons. First, it's not pro forma, at least we're told, in the mind of many benefits managers and CFOs. They would prefer to make the measurement without having to communicate to the employees what their expectations are. Second, and more important, the whole structure of accounting for employee benefits, both benefits and cash pensions and the in-kind benefits in an OPB plan, rests on some notion of implicit contract between employer and employee. We have to have some notion that we are accounting for what the employee expects that he or she will receive. One of the critical elements of contract, if you go back to basic business law, is notice and understanding. There has to be some exchange of information between the parties to the contract if they're both to understand and have a similar expectation of what the benefit is, and so communication is going to be a key element of the substantive plan. Finally, and just to reemphasize, the whole substantive plan approach applies only to cost sharing. It does not apply to plan amendment. And so one cannot say, "Well, I'm going to drop this or that coverage and make that part of my substantive plan," or that, "I anticipate over time dropping this or that coverage." That would be a plan amendment. We have particular and unique accounting in the document, as we did in pensions for dealing with plan amendments.

Now, that's the most significant change so far, but we've got a few others, and let me work through them. As I mentioned in talking about the substantive plan, the OPB document requires one to project into the future to determine the ultimate costs of satisfying the liability, the cash that will ultimately be paid when the bill comes due. It requires that one use a cost trend rate and provides some relatively detailed rules about how one applies that cost trend rate. Those rules in the final document will be somewhat relaxed, particularly in dealing with the notion of the costs to which the trend rate is applied. This is a little bit of inside baseball. Those of you who are familiar with the exposure draft know that it worked on per-capita health care costs, if you visualize that at the top of a work sheet, and applied a cost trend rate to those and then reduced those by coinsurance, deductibles and those sorts of things to come down to a notion of incurred claims. Many of the Academy representatives in many companies told us that companies don't really know what per-capita health care costs are because they never see those data. Nobody ever captures it. It's not subject, in many cases, to being captured or not amenable to being captured. So, the only thing that a company may know is its incurred claims costs, the amount of the bill that's actually submitted to the employer. In the final document, you'll see some loosening that allows you to work from incurred claims and make an adjustment to the health care cost trend rate to reflect that fact. So, we've introduced some flexibility in projecting the future costs of health care in building your ultimate cash flows to be paid.

The health care cost trend rate itself, which has been very controversial, remains a company-specific trend rate assumption. We've had a number of suggestions, and I might digress here and say that one of the few groups that supported the notion of

company-specific trend rate assumptions was the Academy. We've had a number of suggestions for other trend rates, other inflation rates that might be used, other sources of information about inflation. The Board rejected all of those primarily because they all failed two tests. One, they weren't demonstrably simpler, and two, in many cases, they were demonstrably unrepresentational. For example, it doesn't make any sense at all in the short term to use the consumer price index to project health care costs. It's simply not an adequate estimate. You'd be entering into your estimation process knowing that at least in the short term, you are absolutely certain that your estimate is wrong, and that seemed inappropriate. Attempting to develop any other health care trend rate did not occur to the Board to be significantly simpler than allowing data bases to develop that companies can use, and we understand that smaller employers will not be able, from their data, to develop their own trend rate. They will have to look to data bases of information, to regional information, regional demographics, but that's a much more faithful measurement than just taking some number like CPI and using it.

Well, if we inflate into the future, we also have to recognize the fact that costs paid in the future have some present value significantly less than their ultimate amount. The exposure draft spoke of the discount rate in terms that led many people to believe that the Board's objective was a settlement rate, much like the rate inherent in the settlement of a pension liability. We received a lot of complaints from people who argued, quite reasonably, that there is no settlement rate for something that's absolutely impossible to settle. No insurance company in their right mind would settle an employer's liability for postretirement benefits. As a digression, I've often commented that if that's true, one ought reasonably to question the employer. If there's no insurance company crazy enough to take on the same promise, what was the employer doing? But I digress. In any event, the discount rate description is really designed only to measure time value of money. It's not a settlement rate notion. It's not any notion that attempts to capture the risk inherent in estimating future cash flows of this type. It's a discount rate designed only to reduce those future payments to a present value, period, very simple, straight-forward sort of a notion, and we'll be clarifying that in the final document.

Moving into the disclosure area, this is another area where the Board has made significant change, primarily in response to comment. Steve mentioned that in the exposure draft, there was a requirement for an animal called a minimum liability. Some have characterized this as a pain threshold number. If the amount of liability not yet recognized in the financial statements because of a phased-in transition exceeded some amount, we ought to put something on the balance sheet. That was the genesis of the notion of a minimum liability. I think it's fair to say that if we received 500 comment letters, 497 of them opposed minimum liability. The Board, in looking at it, agreed with them, frankly, that the minimum liability notion doesn't communicate anything to the reader of financial statements beyond what's already in the financial statements and the footnotes. There's no additional information content there. So, there seemed to be nothing gained. The minimum liability recognition and the minimum liability disclosure have been deleted, at least as we stand right now.

There are other items of disclosure. We have dropped the vested benefit obligation. This was the idea of disclosing a walk-away benefit, and if all the employees packed up and left, what would the obligation be? There was some notion in developing the

exposure draft that that would be helpful information for financial statement analysts and users. As we came into the comment period, frankly, they said, "No, we're not sure what we'd ever use that for." There was also a notion that it was a relatively simple number to develop. The Academy came along and said, "No, it isn't that simple to develop. It's quite a bit of work, frankly." Faced with the fact that we had a disclosure that nobody wanted to use and that cost a lot to do, even the FASB recognized that perhaps we should change. And so we dropped the vested benefit obligation. It doesn't always take a ball bat to convince us of something, sometimes just a two by four.

Finally, moving to transition, the exposure draft was effective for years after December 15, 1991. We've moved that back a year. So, you'll start to see these liabilities appearing in the first quarter financials for calendar 1993. There was a two-year hiatus in the exposure draft for small companies which had been defined using 100 employees, the ERISA cutoff. We've revised that description of a small employer to be one with 500 employees or plan participants. I have to say, having been in a small CPA firm, if I'd had a client with 500 employees, I would have sat up and watched them all night. It would have been my biggest client. But 500 seems to be the number that many of the government agencies now use as a delineation between, certainly in the manufacturing sector, small and large business.

Perhaps more important for many companies, we've changed the transition to allow a company to take a one-time transition to OPB. In the exposure draft, the Board took the approach of saying everybody's going to do this the same way, and everybody's going to take what's effectively a cash-through-accrual adjustment and spread it forward over remaining service period or 15 years. That was the exposure draft. Many companies came back to us and said, "No, we don't want to have to spread it forward like that. We want to take a one-time adjustment. We want to get religion, get right with the world and go forward." If you think about it from the CFO's standpoint, there's a certain rationale to that. You only have to explain that adjustment to the analyst community once and you don't have this transition ball and chain dragging on your earnings for the next 15 years. And so we had a lot of proposals that we ought to at least allow companies that wanted to take a one-time adjustment to do so. Interestingly, on the other side, we had a lot of proposal that we ought to spread the transition over some longer period. I heard suggestions up to 60 years. In any event, where we stand now is that one-time adjustment is permissible but not required. So, you will have some difference between companies as they begin to adopt. Some, who either have enough earnings to take the hit or who already are in such bad shape that it doesn't make any difference anyway, will likely take the approach of taking a one-time adjustment. Other companies will likely spread it over a period based on average remaining service period or 20 years. We did move that five years out from the 15 that was in the original document.

Two other topics I'd like to touch on quickly. The one thing that the Board is deliberating was probably the most controversial issue in this entire project, and that is the question of the period over which the service cost piece of an OPB liability should be attributed. The exposure draft looked at the typical 55-and-10 plan, that is, 10 years of service and attained age 55, and said, again based on this notion of implicit contract, that by the time an employee has reached 55 and served 10 years with the company, they've done everything they need to do. There's no exchange left to be had. Future service

gains no incremental benefit. So, the exposure draft talked about full eligibility being the point at which attributions cease. Again, about 497 out of 500 comment letters opposed that because of the simple fact that the average employee, we're told, retires at 62.5, not 55, and even an accountant understands that if you amortize something over seven years longer, the hit in each individual period is somewhat smaller. The Board had a lot of difficulty moving to some notion that would allow attribution to retirement date and defining the situations in which you would effectively ignore the contract and move to some other date in the future. There is no support among Board members, at least there wasn't when I left, for an unconditional approach. There has to be some condition or defining state of nature that tells you when you're going to attribute past the full eligibility date. That's what they're meeting on, a proposal that would describe a condition for attribution beyond full eligibility. I, frankly, don't know which way they will fall. I never bat better than .500, and on this one, I wouldn't even venture a guess.

One final point before I sit down and let the other panel members pick up. Measuring postretirement benefits for many companies will create a significant deferred tax timing difference. Stated simply, we've got an accrual on the books that is not deductible for tax purposes when accrued, not substantively different from a warranty accrual which you accrue on the books, but you only get a deduction when you pay. That will create a deferred tax debit. Under the existing accounting rules, for many companies that will be what we call a naked debit, meaning that there are no deferred credits that offset. It starts to look like an asset. Under the existing accounting rules, either the old APB 11 or the new Statement 96 that's currently in limbo, that asset is not recognizable in the financial statements, and so for many companies, the effect of OPB is not, as they might otherwise expect, 66 cents on the dollar being its net of tax effect on the bottom line in that income. It is 100 cents on the dollar, and that makes it a particularly significant problem for many preparers. The Board is currently deliberating approaches that would allow recognition of that asset. Deliberation of those issues will not stop OPB from moving forward, but you need to recognize first that there is an interaction between this item and accounting for income taxes and that the change in accounting for income taxes may have some effect on how people think about the postretirement obligation.

MR. MESKIN: Our second speaker, Marty Levenson, will discuss the financial implications of the proposed standards. Marty is an associate of the Society with over 20 years of experience in investment planning and investment analysis at the Martin E. Segal Company.

MR. MARTIN LEVENSON: We've been hearing about this statement on employee accounting for postretirement benefits since well before the standard was published back in February 1989, and now anticipating the final publication this year, we're still going to have another extended period before corporations need to make final commitments as to how they're going to deal with the broad variety of issues that the standard presents. So, this is a subject that you're really going to be hearing a lot more about in days to come, and I think that's a very good thing for a variety of reasons. The fact is that in many cases, postretirement health care programs, in particular, were allowed to develop without any coherent plan as to the scope of the benefits, the extent of the coverage or the means to be employed in meeting the costs. In fact, Wayne referred to that kind of circumstance in passing in his comments earlier.

Whether the existing plans were well-conceived or not, the proposed standards introduce new concepts and procedures that will need to be weighed and tested under real-life conditions. In fact, what we're dealing with here is really an absolutely marvelous opportunity for consultants. When I got into the pension consulting business many years ago, there was no ERISA, and while there were rules and regulations that we felt from the perspective of that time were perhaps more onerous than they needed to be, in fact, there was a wide range of choices available to plan sponsors and their advisors as to how individual retirement programs ought to be structured. Many of those choices and degrees of freedom have withered over the years with increasing legislation and regulation so that nowadays many questions that arise with regard to pension plan design can be answered simply on the basis of regulation and statute with little reference to the characteristics of the particular company or the particular group of participants to be dealt with. That's not the case with regard to the area that we're dealing with. There are not well-established rules with regard to health and welfare programs, with regard to plan design, with regard to coverage rules, or with regard to vesting as a concept, and hence, there is a wide range for decision making in carrying out the mandates of the new accounting standards. Furthermore, in the case of pension plans, we're dealing with programs that are essentially tax exempt. The monies going in are monies that are before tax, and the investment earnings on the funds are not subject to any taxation. The fact that a participant has to pay tax on the proceeds when he ultimately retires is his problem. It's not the company's problem. Here, we're dealing with a very different set of circumstances. Here, tax considerations are key, and because individual companies will find themselves in very different tax circumstances, it is not possible in advance to set out general rules as to funding and other issues that bear on the incidence of cost that will make sense across the board. Hence, this is really an area where consultants need to focus in on the particulars of each individual client's situation in great detail in order to determine how to move ahead. In fact, with all of the freedom available, sponsors of postretirement health care programs need to deal with a broad variety of advisors. Lawyers, actuaries, accountants, benefit design consultants, investment advisors and others will all have opportunities to address the practical issues that the proposed standards raise, and all will have answers to suggest. I think a key challenge will be to choose answers from those various providers of service and advice that fit together reasonably and serve the interest of both the company and the plan participants.

Now, accommodation to the new standards needs to deal with a wide variety of different subject areas. Obviously, plan design is a key consideration. Plan design would be a key consideration these days even without the accounting standards that we're dealing with because of the way costs have escalated over the years. In any event, I think the accounting standard brings issues to a head, and much attention will need to be given to what benefits should be provided, for whom, and generally, a comprehensive review of the characteristics of the benefit program.

Regarding cost calculation options, people are going to be moving from the pay-as-you-go kind of approach that's been in place to new procedures in accordance with the standards, and as you've heard, the standard talks about a uniform way of approaching the cost calculation issue. However, there are options with regard to phase-in, with regard to amortization, with regard to the choice of actuarial assumptions, and in a variety of other areas that do need to be addressed and considered in some detail.

Funding decisions and vehicles is an area that will require a good deal of attention, in part, because of the differences in tax consequences, in part because of a whole variety of other practical benefit planning and administrative considerations. Should assets be accumulated in advance or not? And, if so, through what kinds of vehicles are important issues to be considered? And once you've decided on the funding vehicle, your job isn't done because within each of the funding vehicles, there may well be significant flexibility as to how the monies ought to be invested. So, consideration will have to be given to that area as well.

Throughout all this decision making, it's going to be necessary to keep in mind the added complication of the tax implications of alternative approaches, and I thought that the last point that Wayne made was particularly telling with regard to the notion of a deferred aspect to the taxation so that the current hit of any particular charge would be more substantial in its effect on current after-tax basis than would otherwise be the case.

We're not going to speculate, I don't think, about the possibility of federal legislation to create fully tax-exempt vehicles for health programs such as those that currently exist for retirement plans. I think just on the basis of the budget deficit situation that we're dealing with, that kind of a development would be extremely unlikely, and really I think there is a basic question as to whether it really makes sense to have a fully tax-exempt vehicle available for these kinds of programs generally, given the fact that the benefit disbursements from these plans are not taxable income to the plan participants, as are the retirement benefits disbursed from qualified trusts.

Plan design kind of considerations lead into, and have implications for the funding and investment considerations that we want to examine. The issues here are really very different from those that relate to the pension plans. The question that you first need to deal with is precisely who it is that you want to cover. Under ERISA, you've got coverage requirements with regard to retirement plans that are not relevant here. So, there is a broad range of choice available as to which employees you are going to deal with. There are choices available with regard to the treatment of dependents under the program, and indeed, with regard to surviving dependents after an employee has passed away, a retired employee, or possibly even an active employee who was eligible to retire but chose not to.

The question of when coverage starts needs to be considered in two senses. It needs to be considered in the sense that Wayne was referring to in his discussion of accrual so that you need to decide when it is in a person's employment that you should begin counting service toward the accrual of these retirement benefit rights. The other area that you need to think about is when the coverage should be applicable in the sense of when benefits may start. I don't think it's necessarily obvious that people need to be covered fully in early retirement years, as many plans have done in the past. It may well be that companies will want to consider whether coverage in early retirement years is something that they want to do under the terms of this plan, or whether it's something that they might choose to deal with on a more ad hoc basis that doesn't require formal cost accounting the way this program will.

What benefits are we talking about? I think there is a very high likelihood that the traditional kinds of indemnity programs that we've seen over the years are going to be withering away, replaced by scheduled benefit kinds of programs, defined dollar contribution approaches where a set amount is committed by the company, and it's then up to people to determine how those funds will be applied in conjunction with the company as circumstances develop.

And, lastly, the source of financial support for the program is going to be an important issue. Employer-pay-all or contributory is obviously a significant question, and, if contributory, whether it's contributory for everybody or dependents only or some combinations of duration of service under the program. In all of these areas, I think we would expect the general trend to work in the direction of reducing or at least controlling the cost exposure of the corporate sponsor. The kind of open-ended indemnity programs that we've seen in the past, I think, are likely to disappear, and that may be helpful in the broad focus on seeking devices to help control medical care costs generally.

With regard to the question of cost calculation options, one of the things that's kind of strange and wonderful for a pension actuary to focus on in the context of these programs is that we're dealing with a set of calculations that incorporates a discount rate for liabilities, as well as an expected return rate on assets. Now, in pension plan valuations, those are one-and-the-same number. You discount the liabilities by using the rate that you assume is going to be earned prospectively with regard to the investment program, and indeed, you give consideration to how the assets are currently invested, and you give consideration to the nature of the security markets within which the fund is going to be dealing in selecting that particular rate of return. Here we have a situation that explicitly provides for different rates for the two purposes. The rate at which you discount the future liabilities is not necessarily the rate that you expect to earn on assets. There may be tax differentials that are involved in considering what rate should be used for the various purposes, and there can be a variety of other reasons for using different numbers for those two considerations. Wayne pointed out the change that is being made in the proposed standard to delete the reference to a settlement rate since everyone recognized that there was, in fact, no mechanism for settlement that was available. He indicated that the final version is going to be very simple and straight-forward, simply indicating that it's a rate based on what's going on generally in the marketplace. There are a lot of things going on at the same time in the marketplace, and I think this is an area where a lot of consideration needs to be given to precisely what the basis for these various rates ought to be.

While the standard talks about giving recognition to market value changes in valuing the assets of a funded program, it also indicates that there's flexibility available and how those assets are to be valued. It provides for some spreading of market value fluctuations over a period up to five years, so that decisions need to be made as to precisely what asset valuation approach you are going to be using. The procedure for cost calculation entails amortization of unfunded costs, and there are decisions to be made with regard to the duration of the amortization period that you're interested in using. Wayne spoke of the option to take an upfront hit all at once with regard to accrued obligations.

The substantive plan issue is also one that I think is going to require a good deal of forethought and planning from a cost calculation standpoint. I think the principles that have been enunciated here are logical and attractive. However, I think there are an awful lot of real practical difficulties in determining in a real-life, practical situation just when it is that a consistent pattern has developed, what it is that qualifies a particular circumstance as likely or feasible. Even issues dealing with communication, which were an important component of determining whether or not there was a substantive plan provision that needs to be accounted for, raise questions as to how and when that kind of information needs to be communicated to the participants in the program.

With regard to funding of these plans, as you know, we've been dealing with a pay-as-you-go kind of approach in the past. Under the standards that we're talking about here, no cash needs to change hands in connection with the assessment of cost, but you do need to reflect liabilities on the books so that we're talking about a book reserve approach as one possible way of dealing with this kind of program. That has some attractive features to it. It leaves the money in the corporation so that the corporation can use it as flexibly as it wishes to meet its ongoing operational requirements. It lets you change ground in the event of tax law changes in a way that best suits your advantage. It may, in fact, provide an opportunity for a superior after-tax rate of return if, indeed, the company's basic business is doing well, so that the assets that you have committed growing within the company are, in fact, throwing off an attractive rate of return. On the negative side, of course, is the fact that that kind of a program secured by a book reserve is not going to give an awful lot of comfort to the plan participants. These are not assets that anyone can get their hands on in a specific kind of way. They are not committed to the benefit program, and in these days of mergers and acquisitions and corporate reorganizations, quite apart from the financial problems and difficulties many corporations find themselves dealing with, the risks that are being put on the plan participants through that kind of approach are not insignificant.

It is, of course, possible to have a program that does not pay out assets or pay out money to an outside funding vehicle not controlled or owned by the company, but nonetheless, has a kind of internal commitment to a pool of assets that could be used for supporting the kind of benefit program that we're talking about here. Insurance companies have responded to that kind of an interest through offerings of company-owned life insurance policies to fund these kinds of programs using the rationale that these insurance policies are, by their nature, giving you an accumulation that is free of income tax on a year-by-year basis, and hence, offers an advantage in that regard. And, indeed, you could have a program that was invested in municipal bonds or other kinds of assets to either capture some tax advantage or to accumulate a diversified pool of investments which might be used for the kinds of purposes that we're talking about here. However, those would not be plan assets, as that term is used in the actuarial standard, and they would not be monies on which the earnings would be an offset against the calculated cost of maintaining the benefit program.

There are some alternatives available that do offer some tax advantages. Section 401(h) of the Internal Revenue Code allows for arrangements in conjunction with a pension plan that offer certain tax advantages. The investment earnings on 401(h) trusts are exempt from taxation, and the money going into this kind of plan is before the

application of corporate tax rates. Unfortunately, however, there are fairly stringent limits on how much you can put in to a 401(h) program. There is a contribution limit equal to 25% of what you're actually putting into your pension plan, and if your pension plan is a very well-funded program, and if you're putting little or nothing into that, 25% of it may not go very far at all toward meeting the cost of the kind of health care program that we're talking about here. However, for some companies in some circumstances, this may well be a very practical kind of solution that captures tax advantages and in their circumstances allows the program to accumulate money in a way that represents plan assets because the monies are segregated and allocated specifically toward the retiree health care program. This will help with the employees' appreciation of the security of what's being promised and from those standpoints might be an attractive alternative.

Another approach that can be considered is through 501(c)(9) trusts, the kind of trust that you run into all the time in the multiemployer benefit area. These are multiemployer plans, collectively bargained programs covering employees in a wide variety of companies where health benefits are typically provided through this kind of trust and where, because of special provisions in the code, the trusts are actually tax exempt in that context. Those kinds of trusts in the context that we're talking about here, in the context of single company plans not collectively bargained, are basically taxable trusts. Nonetheless, you can make a tax-exempt contribution to these programs, again within limits. It may well be that that kind of program also will be attractive because it provides a pool of money that secures the benefit promise that represents plan assets under the accounting standards that we're talking about and may provide for some flexibility in terms of actually rolling over those assets to some other kind of vehicle as circumstances change.

As for investment choices, we've talked about a wide variety of ways of approaching the accumulation of money to meet the ongoing obligations of this kind of program. I think that there is a wide variety of investment vehicles or securities that can be used in conjunction with these programs. I think, given the discussion that we've had of the necessity of making any of these programs specific to the circumstances of the sponsor and specific to the interests of the plan participants, you can see that it is next to impossible to come up with any kind of general instruction as to what ought to be done here. Plans will differ in the extent to which they are inflation sensitive. Plans will differ in terms of the time horizon for the accumulation and disbursement of monies. Plans will differ in terms of the tax consequences to the sponsoring organization and the tax circumstances of the participating employees. All of those factors will need to be taken into consideration, in addition to the traditional analysis of securities, simply in terms of what it is they're likely to produce by way of investment earnings in the future. So that stocks, bonds, be they Treasury bonds, municipal bonds or corporate bonds, cash equivalent investments, life insurance policies, and other specialized vehicles that insurance companies may produce are all possible investment choices to be used in this program. I think that at this point, it really doesn't do much good to try and speculate as to what might be the appropriate combination for any particular kind of program.

I think what you see here is that there is ample room for study and investigation and consideration with regard to the implications of the accounting standard, and I think a

lot of you are going to be doing some hard work in all of those areas over the couple of years that lead into the actual implementation of the standards requirements.

MR. MESKIN: I have in front of me *The Wall Street Journal*, and I'm a practicing actuary doing retiree health matters, and I have a retiree health plan with a stable retiree group. Now, I'm going to ask my panelists if they can give me the thought processes they might go through in trying to determine what discount rate I might use.

MR. UPTON: I'm glad you didn't ask me for the rate itself. I assume that's the reason for the problem. Because even in a plan with a stable retiree group, I couldn't tell you for sure. I can tell you, though, the thought process, and the thought process isn't particularly different than the one you would go through if you were doing a pension valuation under Statement 87. I do differ a little from one of the comments Marty made, because in Statement 87, for financial statement recognition purposes, the return on plan assets and the discount rates are also two different numbers. I suspect you were talking in the tax context. So, I'm going to go through the same process. I have a series of cash outflows that, unfortunately for my purposes, extends 60 or 70 years into the future, which complicates my life. I'm going to look at the interest rates on high-grade debt securities not limited to governments but certainly limited to a certain quality of high-grade corporate securities that would provide me cash flows to match my cash outflows, almost an immunization notion. Ideally, I would construct a hypothetical portfolio of zero coupon bonds. Unfortunately, I don't know of any of those with a 60 year maturity. So, I have a certain reinvestment risk I have to be cognizant of and thinking about. But having put that together, I would then be constructing a weighted average discount rate that discounts each of those cash flows at an interest rate appropriate to their duration. If you tell me who the retirees are and tell me when the cash flows are and tell me what the yield curve is, then we can start to put together the discount rate. It's going to be different for every company, but it'll be different because their demographics are different.

MR. LEVENSON: I guess the question that I have in my mind is whether, as part of the recognition of differentiation among circumstances, you would take into consideration in setting the discount rate the fact that this particular plan intends to finance the program with a 501(c)(9) trust and intends firmly to invest in municipal bonds in order to carry out that policy. Would the tax-exempt nature of those bonds, and hence, the lower interest rate they provide, influence your thinking with regard to the appropriate discount rate?

MR. UPTON: No, not with regard to the discount rate. The discount rate should be an independent determination. If the company invested entirely in junk bonds or in corporate-owned life insurance, and I don't mean to equate those two, regardless of what the investment pattern is, the discount rate has to be independent.

MR. LEVENSON: I certainly don't have any insight into the discount rate determination process that is different than what Wayne has described to you. I'm not so sure about fully understanding the consequences of using that procedure to set a discount rate as opposed to a somewhat different procedure to develop the expected return on the

assets that you're actually going to be using and carrying out the funding program for the plan.

MR. CLYDE D. BEERS: I have a question for Mr. Upton. Let's say that we have a company-active plan which is combined with a pre-Medicare eligibility group so that they're all in the same pool with respect to the plan of benefits, except for the fact that the company requires retirees to pay the full cost of that plan, and let's say that the average cost of that plan is running at $300 per month. Let's second postulate that the expected cost for the pre-Medicare group based on an age and plan-specific basis actuarially is $400 per month. And, third, let's assume that on average, over the last couple of years, because of some large claims, the cost is running at $600 per month for that group. Should the cost for FASB purposes be based on 0, 100, 300, or some other number?

MR. UPTON: You lost me at the bakery. Either we're going to have to start the question over again and take it in steps or you and I are going to have to chat later.

MR. BEERS: Maybe it would be better for later.

MR. UPTON: Ok.

MR. BEERS: If I could change a question, then, of what order of magnitude do you expect the health cost trend to be?

MR. UPTON: I would expect that most companies will use a graded assumption, as was used in the field test that Coopers and Lybrand did in conjunction with the Financial Executive Institute. I would suspect that in the short duration, the short term, they will project, as most people in the media project, a fairly steep health care cost trend rate, but I suspect that most people will put some kind of a limiting assumption on it, as did the people at Coopers, and say that it can't go on that way forever. It's going to have to grade down over time to reach something that in the long term may even approximate general CPI.

MR. JOHN J. SCHUBERT: My question is for Wayne, and it has to do with the one-time hit. Under the Board's current position, will a company be able to recognize only a portion of the APBO or will they have to recognize the entire portion? Here I'm trying to get towards just the retiree portion.

MR. UPTON: In other words, you would propose that a company could just recognize the retiree portion of the transition obligation?

MR. SCHUBERT: Correct.

MR. UPTON: No. The one-time hit is the entire transition obligation. We're not going to split it up.

MR. SCHUBERT: Along those lines, then, if you look at it a little differently rather than retiree versus active, if you look at division by division, would a company be able to recognize the liability for a particular division?

MR. UPTON: Absolutely not. A company sets its accounting principles for the entity as a whole, and with very rare exceptions do we have different accounting principles in different parts of the entity.

MR. SCHUBERT: This company, in particular, is a coal mining company with separate . . . .

MR. UPTON: You would say separate subs or something like that? No, on the consolidated statements, you've got one accounting principle, and it's either recognize or spread for everybody. The only time in accounting that we have different principles in different parts of an entity is when we have industry-specific differences. Like a company that has a property casualty and a life division, we have a little bit different accounting for those.

MR. DANIEL M. ARNOLD: The exposure draft, as I recall, calls for the setting of the discount rate and the other assumptions to be the responsibility of the plan sponsor. Do I recall that correctly?

MR. UPTON: Yes, of the employer.

MR. ARNOLD: So, it's not the actuary's best estimate. It's tracking like FAS 87.

MR. UPTON: No, I think you're making a distinction without a difference. The employer is always responsible under 87 or this for the assumptions. They are the employer's financial statements. The actuary assists the employer, probably tells the employer what to do in many cases, but they're the employer's responsibility.

MR. ARNOLD: May I ask an additional question? In the discount rate question which is intended to measure the time value of money, if I got your logic right or your comment right, I guess I'm a little confused, and maybe you could help me with this. Most of the plans that I deal with are in the 200 life, let's say, to 5,000 life range. So, for that group of companies, which I guess I would call a second tier group of companies versus the Fortune 500 or Fortune 1,000 companies, we have a little more latitude generally than the accounting profession allows because of materiality issues involved. Is the setting of the discount rate in your view likely to differ by the size of the company that you're dealing with?

MR. LEVENSON: To me, I don't think the size is a key consideration. I think the demographic characteristics of the employee and retiree population are relevant characteristics, though. I think you could come to a very different answer if you were talking about a newly-formed corporation that has no retirees and the average age of whose employees is 25 than you would come to for a mature organization in a declining industry that has two retirees for every active employee. I think it's that kind of difference in circumstance that creates a different durational character to the liabilities

that would have an impact on the discount rate, not the sheer number of people involved.

MR. UPTON: If anything, and my information is strictly anecdotal, my understanding is that in the pension environment for small plans, the assumptions for discount rates have focused more on the PBGC and Treasury instrument rates than on the high quality government bond rate. So, if anything, in the smaller company environment, there may have been some skewing of the discount rate toward the lower side, but that's strictly anecdotal. I don't have any other basis for that.

MR. MICHAEL D. SCHACHET: Question for Wayne. On your first substantive change that we should expect in the final FASB statement you referred to -- that we're supposed to look at the substantive plan. Suppose I have an employer who has gone to a defined dollar benefit such that the employer says he'll pay the first $500 per employee, and then the employee pays everything after that. The way he communicates it is to say we pay the first $500, but we have the right to increase the amount that we'll pay for, and, in fact, we do expect to increase what we pay for in the future. Really the only reason to go to this defined dollar is to beat the FASB statement and have a small expense.

MR. UPTON: Economic cost having nothing to do with it?

MR. SCHACHET: I don't mean I see only one, but that is a prime consideration. How does that sit with what will come out?

MR. UPTON: I think that's, again, not significantly different than if you had a pension plan with an established track record of increasing the benefit. The substantive plan in that case would be an increased benefit, and the communication would be, in effect, the history. The key communication, then, that you would have to look at is whether or not the company has communicated an intent to change that pattern.

MR. SCHACHET: They would communicate a right to change. I don't think they would communicate an intent to change.

MR. UPTON: Well, if the company for the past 15 years has consistently ratcheted up that plan, then, just as with a cash pension plan which is very close to what we're talking about here, in the absence of evidence to the contrary, you ought to continue to assume they're going to ratchet it up and build that into your assumptions.

MR. SCHACHET: I would agree with that. When the client first puts this plan on will be approximately the same time the statement takes effect, and I'll have no past experience.

MR. UPTON: Then you're going to have to look at what they've communicated to the employees, and you may be stuck with saying that it's just this much until you build up some experience.

MR. SCHACHET: Ok.

MR. UPTON: That points to a trend that we have been told a lot of people are doing, and that is to put in a dollar value plan. That's, in part, I'm sure, in response to the financial statement hit and, in part, too, to the effect of the economics that they face.

MR. EDWARD M. MAILANDER: I have a question for Mr. Upton. On the changes to the exposure draft or the proposed changes or contemplated changes on the substandard plan rules, you had said that applied to employee contributions. Does that also apply to employee cost sharing or retiree cost sharing?

MR. UPTON: Yes. I was using the terms, perhaps, precisely as the same -- talking about a retiree cost sharing.

MR. MAILANDER: So, a company that had a history of raising the deductible . . . .

MR. UPTON: Yes.

MR. MAILANDER: Then a second question. In my recollection of the exposure draft, there were two implementation dates, one for accrual and then one for the balance sheet liability. Is there any change in the implementation date for the balance sheet liability?

MR. UPTON: The second implementation date was only for the minimum liability, that extra pain threshold number that I talked about. Since we have no minimum liability, we have no transition date for it.

MR. MAILANDER: Ok.

MS. DIANE S. LUEDTKE: I have a question for Wayne. What are the chances that this package isn't going to be passed by the end of this year? Is there any chance? Because I understand that you're right now under a 4-3, a simple majority, and that next year the voting rules change, and it's a 5-2, and it may be a lot tougher to pass this?

MR. UPTON: Well, right now you have to remember that the exposure draft passed 5-2, and as I say, I don't do very well betting on how Board votes. My understanding is that the vote is no worse than that now. The more difficult problem for timing is not the change in the voting requirement. It's the change in Board membership because Ray Lauver is leaving effective the end of this year, and we don't know, as the *New York Times* so jovially pointed out, who his replacement is. If we don't get it balloted by the end of the year, and I think we will, it would be that transition in Board members that would really mess us up. I would expect that we would try to get it at a 5-2 or even a 6-1 vote.

MR. SCHACHET: I have one more question, and it's a lot like Clyde Beers', and I was just wondering if Clyde would try to ask that question again. I'd really like to get the answer to it.

MR. BEERS: I apologize for the long-winded question. Let me try to express it in words rather than putting the numbers in. I have a situation where the employees who are retired are purportedly contributing the full cost of the plan. Second, I have

actuarial expectation that the actual cost for that group of people is higher than the amount that they're contributing. And, finally, I have actual real experience that the cost for that group over the last three years, let's say, has, in fact, averaged even more than the actuarial expected cost. Do I use the fact that the employer is making the employees contribute the "full cost of the plan," and say there is no cost to the employer? Do I use the actuarial expected cost as a basis for determining the employer's subsidy? Or, third, do I use the actual cost that is being generated relative to the employee contribution as the basis for cost determination?

MR. UPTON: I was afraid somebody was going to ask me the subsidy question. Because as I sat last night going over it, it's the one that I don't remember the answer to. In your case I believe, and if you'll give me your card, I'll get back to you for sure, that you use your actuarial assumptions, and you don't rely on that representation that the retiree contribution is full amount in the face of evidence that suggests that it certainly isn't.

MR. MESKIN: I talked about this with Diana Scott, and she confirms that subsidies, hidden subsidies, are to be valued. Now, between those other two choices, that's a good question, but it's not 0.

MR. UPTON: That's almost always the wrong answer. The auditor in me comes out then, and I say, I know there's one wrong number.