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Accounting for postemployment benefits other than pensions

by Frank Becker

The unfunded obligations of U.S. employers for postretirement health benefits are enormous. While estimates of the obligation vary widely from under $100 billion to over $1 trillion, the Government Accounting Office estimate is about $400 billion. For the most part, accounting and financing for these benefits are currently on a pay-as-you-go basis. Changes proposed by the Financial Accounting Standards Board (FASB) could cause increases in the amount reflected as expense in a typical company's financial statements of 300%-500% over the pay-as-you-go amounts.

Where FASB stands

On February 14, the FASB released an exposure draft of a proposed statement entitled "Employers' Accounting for Postretirement Benefits Other Than Pensions." In 1984, this subject was split from the project on accounting for pensions that led to FASB Statement No. 87. If the history leading up to the adoption of FASB Statement No. 87 is any indication, the final standard on other postemployment benefits will not differ substantially from the exposure draft.

The FASB's goals for this project on accounting for postemployment benefits are similar to those expressed under Statement No. 87, namely:

1. To match the costs of postemployment benefits to the period in which they are earned by employees,
2. To include the obligation for postemployment benefits on the balance sheet,
3. To enhance comparability of financial statements among companies and between accounting periods, and
4. To increase the amount of disclosure included within the financial statements.

The exposure draft is being followed by a six-month comment period and public hearings. A final statement is expected to be released in 1990. For most companies, implementation of the statement will affect the income statement in 1992, and recognition of a minimum liability on the balance sheet will be required by 1997.

Mechanics of the FASB proposal

The FASB proposed methodology for the postemployment benefits follows closely the methodology prescribed under Statement No. 87 for pensions. The annual net cost will consist of five components:

1. Service Cost – for benefits attributed to the current year. If the plan does not prescribe a method for attributing benefits, FASB will prescribe a years-of-service approach for attributing benefits.
2. Interest Cost – on the accumulated postretirement benefit obligation.
3. Amortization of Gains and Losses – which arise from asset returns differing from those expected, changes in assumptions, and other unexpected changes in the accumulated postretirement benefit obligation.
4. Return on Plan Assets – which is a negative component of expense. Unfortunately, unlike pensions, most of these other benefits are unfunded so there would be no reduction in expense from this component.
5. Amortization of Unrecognized Prior Service Costs – over future employees' service. This component would reflect the amortization of plan amendments. Also a transition obligation representing unrecognized obligations that predate the Statement would be amortized.

The accumulated postretirement benefit obligation is the portion of the present value of expected benefit payments attributable to employee service rendered to date. Unlike the approach under Statement No. 87, where the obligation was generally assumed to accrue over the period from hire to expected retirement date, the obligation under this proposal accrues over the period from hire to first eligible retirement date. Another difference between the Statement No. 87 approach and this proposal is that the discount rate used here to determine the present values is based upon long-term interest rates rather than current "settlement" rates. Health care trend rates used to project the obligation would reflect best estimate assumptions of the plan's future experience.

No changes are to be made in the utilization rate nor in items covered. Furthermore, the prospective legal environment with respect to the obligations absorbed by government, the employer, and the employee should be assumed to remain static. (Future changes in Medicare may not be assumed.)

As stated previously, beginning in 1997 a minimum liability will have to be recognized on the balance sheet for most companies. This minimum liability would be the excess of the accumulated postretirement benefit obligation for retirees and active employees eligible to retire over the (for the most part, currently nonexistent) plan assets.

Corporate reaction to the FASB proposal

Since, for most companies, the FASB proposal will require balance sheet recognition of significant liabilities commencing in 1997 and unfunded accrued expense until then, there will be significant ramifications. Loan covenants may be violated, additional loan financing may be curtailed, and interest rates on loans may increase. The health care liabilities of some companies may well exceed their net worth.

In addition to the balance sheet effects, the proposal will have a dramatic adverse impact on reported earnings for most companies. Price-earnings ratios will suffer, and there may be a concomitant reduction in stock prices. But reactions to the proposal will vary. Some employers may not react negatively and thus may make no changes before implementation of the proposal. These employers may conclude that they will be no worse off, on a basis relative to other employers, than before.

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However, many employers will probably redesign their health benefit plans in response to the FASB proposal. Currently, most employers sponsor health benefit plans with open-ended commitments – cost increases for postretirement health coverage are directly absorbed by the employer. Employers may change the open-ended nature of this benefit commitment by reducing the employer-provided benefit or by redefining the commitment. For example, some employers may eliminate the benefits for prospective retirees. Others may increase the amount of deductibles and co-payments employees are required to pay. Some employers may adopt a defined contribution approach with respect to the employer-provided benefit. Under the defined contribution approach, these employers would commit themselves only on an ad hoc basis. Employers who do not currently vary benefit levels based on completed years of service may decide to do so. Employers may cut the level of dependent benefits. Corporations may also pass an increase in recognized costs on to the consumer via price increases. It is important to note that real costs will not have been affected by the proposal, rather only the incidence of such costs.

One corporation, LTV, had a unique reaction to the FASB proposal. LTV recorded $2.26 billion in liabilities for postemployment medical and life insurance benefits in 1988. Since it is in Chapter 11 reorganization status, it apparently decided to recognize the liabilities earlier than required. The effect is to place LTV in a more competitive position after reorganization because it will have already recognized the expense associated with postemployment benefits. LTV referred to the FASB proposal in announcing its decision to recognize liabilities in 1988.

On a more positive note, some employers may seek to attack the problem from the other side – by accumulating assets to cover the obligations. Unfortunately, there is no satisfactory tax-favored funding vehicle available today that could be used to accumulate such funds. Furthermore, in the current period of national budget deficits, little relief can be expected from Washington in the near future. If and when tax-deductible funding is allowed, there would probably be some ERISA-type requirements such as vesting, participation, and accrual rules.

A modest proposal: Use excess pension fund assets to address postretirement health liabilities

On September 15, 1988, U.S. Representative Rod Chandler introduced a bill, The Retiree Health Benefits and Pension Preservation Act (HR5309), which among other things allowed for the tax-free transfer of excess pension plan assets to a trust for retiree health and long-term-care benefits. This proposal was similar to a 1987 Reagan administration proposal that was not implemented. As a quid pro quo, no other asset reversions would be allowed since there would be a 100% excise tax on reversions for other purposes. Excess assets would be those in excess of 125% of plan termination liabilities.

The following suggestions have been offered for implementation of the asset transfer proposal:

1. In order for the security of the pension plan benefit to be maintained, a significant cushion of assets must remain with the pension plan after the transfer. As stated above, the Chandler bill calls for assets of at least 125% of termination liabilities to remain with the pension plan.
2. Unlike asset revisions, asset transfers to a trust for retiree health benefits should not be subject to excise and income tax.
3. Income on the trust should escape Unrelated Business Income Tax and regular income taxation.
4. At least initially, the retiree health trust would cover only liabilities for current retirees. However, the future health cost trend would be reflected in determining the liabilities for this group.
5. The asset transfer would be treated as a plan amendment for minimum required and maximum tax deductible pension plan contribution determinations.
6. The retiree health trust would be the first payor of retiree health benefits, and payments from the trust would not be tax deductible.

Although the ability to transfer excess pension plan assets to a trust to help finance postretirement health benefits is not a complete solution to the inability to fund on a tax effective basis, it is a credible first step. As long as a substantial asset cushion is left in the pension plan, total retirement benefit security would be enhanced. Also, the FASB balance sheet liability would be decreased. Furthermore, since benefit payments from the trust would not be tax deductible by employers, tax revenues would be enhanced at least in the near future. (Based upon a study performed on behalf of a business lobbying group, tax revenues would increase by approximately $6 to $7 billion over the next five fiscal years.)

Summary

The implementation of the FASB proposal will have significant financial and employee benefit design repercussions. Some may argue with the manner in which FASB prescribes reporting the obligation and expense for postemployment benefits. Few would argue, however, with the message that employers' obligations for postemployment benefits (particularly health benefits) are significant and must be addressed.

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AERF Practitioners' Award

The Actuarial Education and Research Fund (AERF) is pleased to announce the second annual Practitioners' Award for research done in 1988. The award recognizes the considerable research done by actuaries working in a nonacademic setting and encourages the publication of research performed in the working environment. Submissions must be made to AERF by June 1. Announcement of the winners is scheduled for October 1. For rules and requirements on the Practitioners' Award, contact Mark G. Doherty, Research Director of AERF, at (312) 706-3500. The top prize is $1,000, and honorable mention prizes of $500 are possible. The AERF anticipates publishing submitted papers in the *Actuarial Research Clearinghouse (ARCH).*