BOP's

Net Present Value Comparison

(In Thousands of Dollars)

Year	Unfunded FAS 106 Cost	8.75% Rate Discounted Amount	Unfunded FAS 106 Net Present Value	Accumulative FAS 106 Net Present Value	Pay as you go Cost	8.75% Rate Discounted Amount	Pay as you go Net Present Value	Accumulative Pay as you go Net Present Value
1991	$2,849	$0	$2,849	$2,849	$676	$0	$676	$676
1992	2,974	239	2,735	5,584	772	62	710	1,386
1993	3,091	477	2,614	8,197	890	137	753	2,138
1994	3,186	709	2,477	10,675	1,025	228	797	2,935
1995	3,306	942	2,364	13,038	1,171	334	837	3,773
1996	3,427	1,174	2,253	15,291	1,304	447	857	4,630
1997	3,551	1,404	2,147	17,438	1,408	557	851	5,481
1998	3,668	1,629	2,039	19,477	1,486	660	826	6,307
1999	3,751	1,834	1,917	21,394	1,652	808	844	7,152
2000	3,858	2,045	1,813	23,208	1,797	952	845	7,996
2001	3,969	2,254	1,715	24,923	1,927	1,094	833	8,829
2002	4,079	2,458	1,621	26,544	2,057	1,239	818	9,647
2003	4,154	2,636	1,518	28,063	2,189	1,389	800	10,447
2004	4,231	2,809	1,422	29,484	2,313	1,536	777	11,224
2005	4,324	2,988	1,336	30,821	2,472	1,708	764	11,988
2006	4,414	3,160	1,254	32,075	2,567	1,838	729	12,717
2007	4,504	3,327	1,177	33,252	2,721	2,010	711	13,428
2008	4,579	3,479	1,100	34,352	2,871	2,181	690	14,118
2009	4,587	3,574	1,013	35,365	3,052	2,378	674	14,792
2010	4,652	3,707	945	36,311	3,204	2,553	651	15,443
Total	$77,154	$40,843	$36,311		$37,554	$22,111	$15,443	

Pay-as-you-go present value	$15,443
FAS 106 present value (unfunded)	36,311
Difference	($20,867)

Net Present Value Comparison
(In Thousands of Dollars)

Year	Unfunded FAS 106 Cost	8.75% Rate Discounted Amount	Unfunded FAS 106 Net Present Value	Accumulative FAS 106 Net Present Value	Funded FAS 106 Cost	8.75% Rate Discounted Amount	Funded FAS 106 Net Present Value	Accumulative FAS 106 Net Present Value
1991	$2,849	$0	$2,849	$2,849	$2,849	$0	$2,849	$2,849
1992	2,974	239	2,735	5,584	2,824	227	2,597	5,446
1993	3,091	477	2,614	8,197	2,759	426	2,333	7,779
1994	3,186	709	2,477	10,675	2,672	594	2,078	9,856
1995	3,306	942	2,364	13,038	2,615	745	1,870	11,726
1996	3,427	1,174	2,253	15,291	2,560	877	1,683	13,409
1997	3,551	1,404	2,147	17,438	2,507	991	1,516	14,924
1998	3,668	1,629	2,039	19,477	2,446	1,086	1,360	16,284
1999	3,751	1,834	1,917	21,394	2,350	1,149	1,201	17,485
2000	3,858	2,045	1,813	23,208	2,284	1,210	1,074	18,559
2001	3,969	2,254	1,715	24,923	2,225	1,263	962	19,521
2002	4,079	2,458	1,621	26,544	2,167	1,306	861	20,382
2003	4,154	2,636	1,518	28,063	2,077	1,318	759	21,141
2004	4,231	2,809	1,422	29,484	1,991	1,322	669	21,810
2005	4,324	2,988	1,336	30,821	1,928	1,332	596	22,406
2006	4,414	3,160	1,254	32,075	1,864	1,334	530	22,936
2007	4,504	3,327	1,177	33,252	1,804	1,333	471	23,407
2008	4,579	3,479	1,100	34,352	1,733	1,317	416	23,823
2009	4,587	3,574	1,013	35,365	1,604	1,250	354	24,178
2010	4,652	3,707	945	36,311	1,545	1,231	314	24,492
Total	$77,154	$40,843	$36,311		$44,804	$20,312	$24,492	

FAS 106 present value (funded)	$24,492
FAS 106 present value (unfunded)	36,311
Difference	($11,819)

Executive Offices

GTE California Incorporated

601 Van Ness Avenue, Suite 2052
San Francisco, CA 94102
415 474-3926 - Facsimile 415 474-6546

In Reply Refer To

June 28, 1991

To Mark Loy - CPUC

Subject On-Going Data Request -
Prefunding PBOPs

Reference Your Data Request 14 - gte

Attached is GTE California's response to the above referenced data request. If you should have any questions, please contact me at 474-3926.

Carol Lam

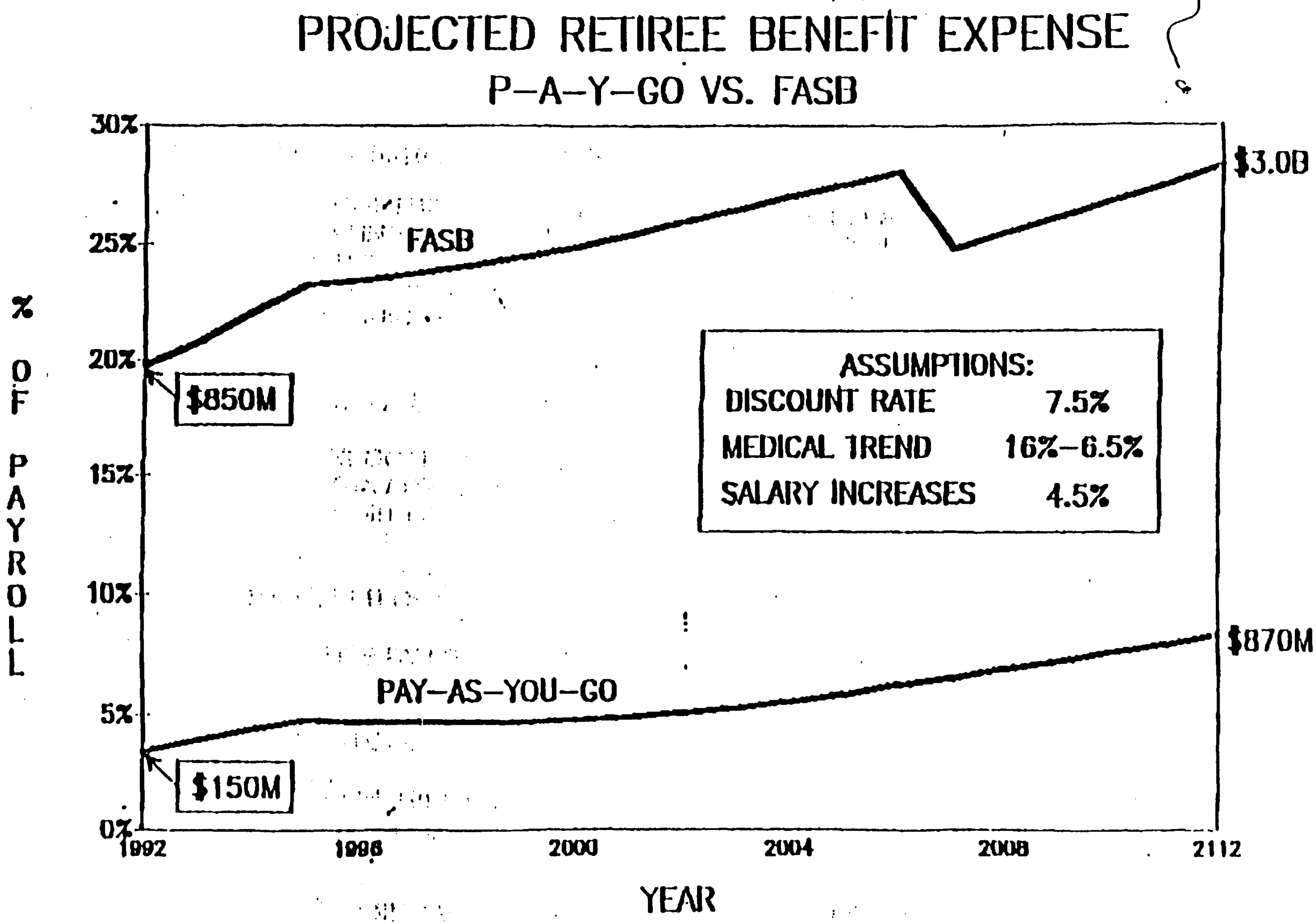
CAROL LAM
State Manager - Regulatory
& Industry Affairs

Attachments

FUNDING
ECONOMIC CONCLUSIONS

FUNDING IS ECONOMIC ONLY IF AFTER-TAX RETURN ON PLAN ASSESTS EXCEEDS GTE'S COST OF CAPITAL

- ONLY LIKELY WITH TAX-FREE EARNINGS IN FUND



PROJECTED RETIREE BENEFIT EXPENSE
P-A-Y-GO VS. FASB
30%
25%
20%
15%
10%
5%
0%
% OF PAYROLL
FASB
$850M
$3.0B
ASSUMPTIONS:
DISCOUNT RATE 7.5%
MEDICAL TREND 16%-6.5%
SALARY INCREASES 4.5%
PAY-AS-YOU-GO
$150M
$870M
1992
1996
2000
2004
2008
2112
YEAR

APPENDIX 5

Impact of SFAS No. 106
on
Cash Flow and Creditworthiness

Excerpts from Independent Sources:

1) Bear, Stearns & Co, Inc.
2) Standard & Poor's, Inc.

April 18, 1991 INVESTMENT RESEARCH

ACCOUNTING ISSUES

PAT McCONNELL

BEAR STEARNS

Bear, Stearns & Co. Inc.
245 Park Avenue
New York, NY 10167
(212) 272-2000

FASB NO. 106 - RETIREE HEALTH CARE ACCOUNTING EARLY ADOPTERS AND FOOTNOTE DISCLOSURES REVIEWED

IBM took a $2.3 billion after-tax charge to implement FASB No. 106. A few other companies have also adopted the new methodology, but the list of early adopters is likely to remain short. However, some managements have disclosed the expected impacts of adoption. This ACCOUNTING ISSUES describes the initial and future impacts the new accounting rule will have on earnings and balance sheets of 32 companies that have either adopted the new standard or were courageous enough to make meaningful disclosure.

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Table 2

SIMPLIFIED EXAMPLE OF A RETIREE HEALTH CARE PLAN
RETIRED EMPLOYEE

Assumptions:

Employee hired at age 25
Employee will work until age 65
Employee will live until age 82

Eligible for medical benefits if employed by the company when retired.

Current health care claims per retiree, net of Medicare	$1,000
Best estimate of the health care cost trend rate	12%
Discount rate	9%

Employee Career:

25	65	82
Hired	Retires	Dies

1) Projected Trend in Health Care Benefit per year per Employee:

25	65	82
Hired	Retires	Dies
	$1,000	$6,866

2) Retiree Health Care Benefit Obligation:

25	65	82
Hired	Retires	Dies
	$21,898	$0

3) Retiree Health Care Expense:

25	65	82
Hired	Retires	Dies
	$3,066 or $1,971	

4) Retiree Health Care Liability:

25	65	82
Hired	Retires	Dies
	$1,946 or $21,898	$0

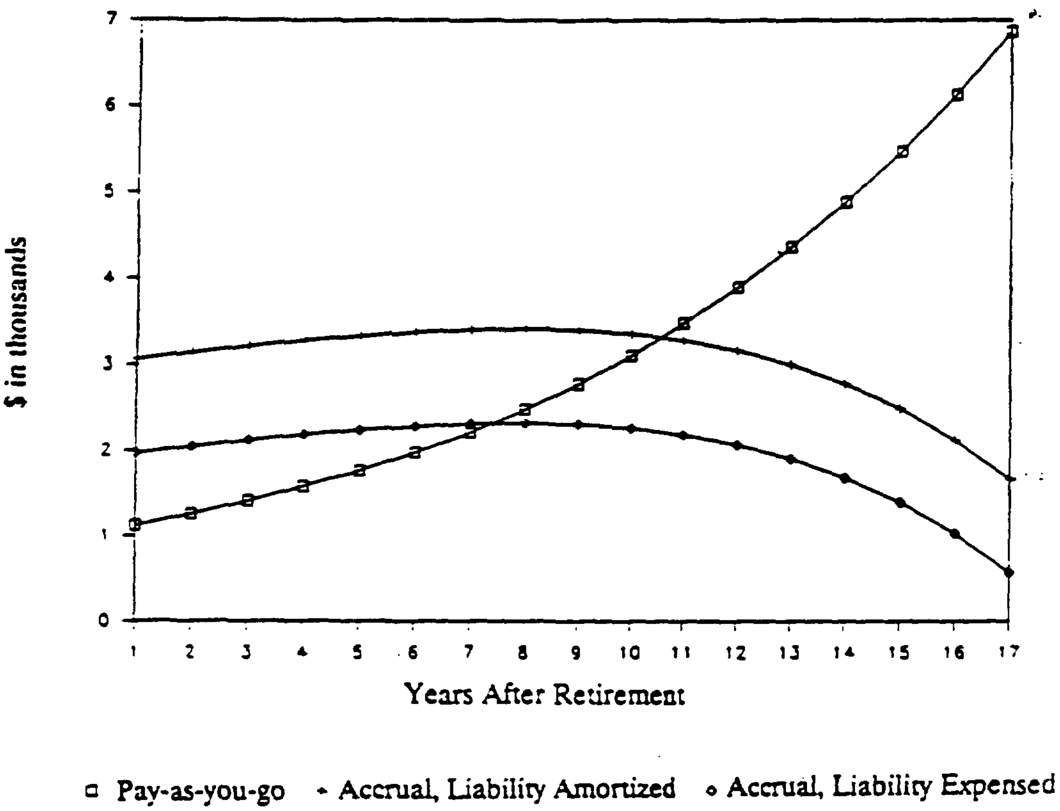
The medical benefits that will be paid out during retirement are calculated as described in Step 1, above. In the first year of retirement, the medical claims are about $1,120. In year 17 when the retiree is expected to die, the claims have increased to $6,866.

The present value of the future health benefits today is $21,898. Since the employee is retiring today, this is a prior service obligation. The new standard gives companies the **option** of recording the entire $21,898 immediately by a one time charge to income or spreading it over the next twenty years. The choice will have a material impact on the size of the retirement health care expense. The alternative expense numbers for the first year of retirement are:

	Record Liability Immediately	Amortize Liability Over 20 Yrs.
Service cost	$ 0	$ 0
Interest ($21,898 X 9%)	1,971	1,971
Amortization	0	1,095
	$ 1,971	$ 3,066

On a "pay-as-you-go" basis, the company's expense is $1,120. If the company elects to recognize the liability immediately, the expense increases to about twice that amount. Using the FASB's 20 year amortization, the expense is three times the amount paid. The relationship of the "pay-as-you-go" expense to the FASB alternatives is shown below graphically. The horizontal axis represents the retiree's life line in years. The vertical axis is dollars.

Retiree Health Care
Alternative Expense Curves

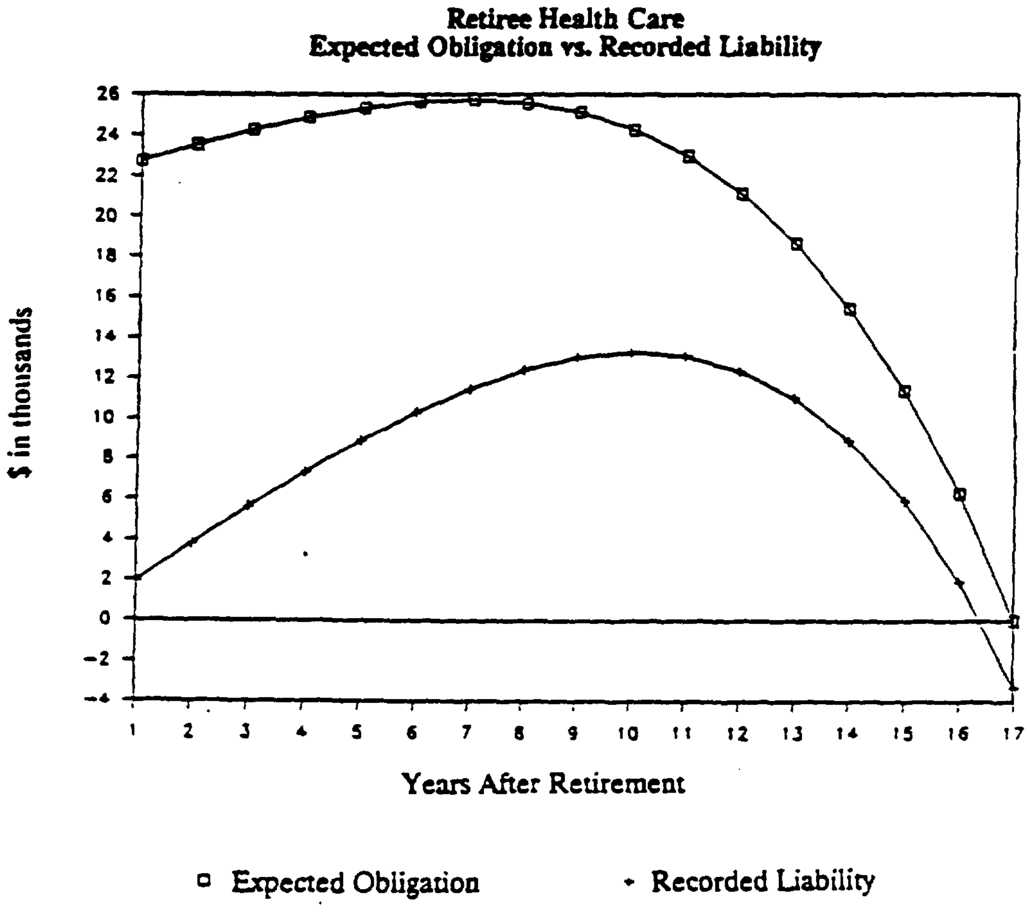


The graph illustrates that this accounting change is a timing issue. Under both FASB methodologies (immediate recognition or amortization of the liability), the expense is higher than pay-as-you-go for the first several years. In the later years, however, pay-as-you-go is significantly higher than the FASB expense.

If the company is amortizing its prior service obligation, the liability recorded in the balance sheet at the end of the first year of retirement is only a fraction of the company's total expected liability. It is $1,946 calculated as follows:

$3,066	Expense
(1,120)	Payment
$1,946	

The maximum recorded liability for health benefits due this retiree is $13,322 after ten years of retirement. The recorded liability and the value of the expected obligation are shown graphically below. The horizontal axis represents the retirement period. The vertical axis represents dollars.



If the retiree dies on schedule, at the end of the 17-year retirement period, the obligation is zero. However, the recorded liability in the balance sheet will actually go negative. The initial obligation is amortized over 20 years, thus the liability has not been fully recorded by the end of year 17. The benefit payment made in that year takes the liability negative. The negative balance is reduced to zero over the next three years by the remaining amortization.

Table 3 presents the results for an employee who has been with the company 20 years. Retiree health care expense for this employee combines elements of the previous two examples. It has a service cost component like the first example and amortization like the second.

Table 3

**SIMPLIFIED EXAMPLE OF A RETIREE HEALTH CARE PLAN
EMPLOYEE WITH TWENTY YEARS OF SERVICE**

Assumptions:

Employee hired at age 25
Employee has worked 20 years
Employee will work until age 65
Employee will live until age 82

Eligible for medical benefits if employed by the company when retired.

Current health care claims per retiree, net of Medicare	$1,000
Best estimate of the health care cost trend rate	12%
Discount rate	9%

Employee Career:

25	45	65	82
Hired	Today	Retires	Dies

1) Projected Trend in Health Care Benefit per year per Employee:

25	45	65	82
Hired	Today	Retires	Dies
	$1,000	$9,646	$66,232

2) Retiree Health Care Benefit Obligation:

25	45	65	82
Hired	Today	Retires	Dies
	$37,691	$211,236	$0

3) Retiree Health Care Expense:

25	45	65	82
Hired	Today	Retires	Dies
	$3,665		

4) Retiree Health Care Liability:

25	45	65	82
Hired	Today	Retires	Dies
	$3,665	$211,236	$0

The value of health benefits owed this employee at retirement are $211,236. The present value of those benefits today, when the employee is 45, is $37,691. The employee has worked twenty of his forty year career so he has earned half of the total future benefits. Since these benefits were not provided for during the first 20 years of employment, the company's prior service obligation is $18,846. As noted above, the company has the option of recording this obligation immediately or amortizing it over twenty years. The first year expense under each alternative is:

	Record Liability Immediately	Amortize Liability Over 20 Yrs
Service cost	$ 942	$ 942
Interest ($19,788 X 9%)	1,781	1,781
Amortization	0	942
	$ 2,723	$ 3,665

If the company does not elect to recognize the entire prior service obligation immediately, the liability at the end of the year is only $3,665.

Health Care Claims and Medicare

In the example above, health care claims per retiree after factoring in medicare payments is assumed to be $1,000. For retirees age 65 and over, Medicare pays for most medical expenditures. The United States General Accounting office estimates that in 1988 employers' retiree health costs were $777 per retiree age 65 and over and $2,602 per retiree under 65. Early retirees are not covered by Medicare and frequently have poorer health when they retire than workers of the same age. Thus, companies that have recently implemented early retirement programs will likely have higher expenses under the new rule than companies whose retirees are older.

Full Eligibility versus Expected Retirement Date

In each of the preceding illustrations, the employee is expected to retire at age 65 when he first becomes fully eligible for retirement health benefits. In the real world, this is rarely the case. Employees frequently are eligible for benefits many years before they are expected to retire. For example, a plan may provide that all employees with the company at least 10 years and 60 or older are entitled to retirement health benefits. However, employees are not expected to retire until age 65 when they become entitled to a full pension.

FASB No. 106 requires that retiree health care be expensed during the period from date of hire to the earliest date an employee is fully eligible for benefits. Thus, if the employee is fully eligible for benefits at age 60, the company must fully accrue the retirement health care obligation by that date, even though it does not expect the employee to retire until 65. This change increases retiree health care expense in the third example above (Table 3) by 14% as shown below.

Table 4

RETIREE HEALTH CARE EXPENSE
ALLOCATED TO ELIGIBILITY DATE AND EXPECTED RETIREMENT DATE

	Expected Retirement at Age 65	Eligible at Age 60
Service cost		
($37,691/40)	$ 942	
($37,691/35)		$ 1,077
Interest*		
(19,788 X 9%)	1,781	
(22,615 X 9%)		2,035
Amortization*		
($18,846/20)	942	
($21,538/20)		1,077
	$ 3,665	$ 4,189
Increase in expense		524
% increase in expense		14%
*		
Value of future benefits	$37,691	$37,691
Multiplied by ratio of years worked to years to eligibility		
(20/40)	50%	
(20/35)		57%
Prior service obligation	$18,846	$21,538
Service cost	942	1,077
	$19,788	$22,615

This is one of the most controversial decisions the Board made. Most companies believe that the obligation should be allocated over employees' full working career up to the date of expected retirement. Less than a week before the FASB released Statement No. 106, the Financial Executives Institute (FEI) was still debating this issue with the Board. Using the longer period favored by FEI would significantly reduce the first year expense for many companies. So far, the Board is sticking by its choice of the full eligibility date.

Health Care Cost Trend and Discount Rates

The health care liability and expense can vary significantly depending on the assumptions used. The two most significant are the health care cost trend rate and the discount rate. The higher the health care cost trend rate the higher the liability and the expense. The higher the discount rate the lower the liability and service portion of expense. It is the difference between the discount rate and the health care cost trend rate that counts; the absolute figures are unimportant.

The discount rate will be the same or very close to the rate used for pension accounting. It is based on a portfolio of high quality fixed income investments with maturities that match the expected timing of benefit payments.

The health care cost trend rate is used to project the cost of providing health care benefits in the future. It is analogous to the salary inflation assumption in pension accounting. The health care cost trend rate is company specific. It is based on a company's own experience and the terms of its health care plan. It takes into consideration expected changes in medical supply and personnel costs, changes in health care utilization or delivery patterns (e.g., more frequent mammograms and more numerous lab tests), technological advances (e.g. CAT scans), and changes in the health status of the plan participants.

Retiree health care expense is very sensitive to the trend rate assumption. The table below gives retiree health care expense for the facts given in the third example above (Table 3) using three health care trend rate assumptions:

Health care costs grow at 12% per year forever,

Health care costs grow 12% next year, then trend down by .2% per year leveling off at 5% per year,

Health care costs grow 12% next year, then trend down by .5% per year leveling off at 5% per year.

Table 5

RETIREE HEALTH CARE EXPENSE
VARYING HEALTH CARE COST TREND ASSUMPTIONS

	Health Care Cost Trend Rate		
	12% per year	12%, declining .2% per year	12%, declining .5% per year
Expense	$3,665	$1,712	$927

Thus, while there is little flexibility in choosing the discount rate, there is flexibility in determining the health care cost trend rate. To help evaluate the rate, the FASB is requiring companies to disclose:

- The effects of a one percentage point increase in the rate on both the obligation and the combined service and interest components of cost.
- The assumed rate for the next year and the ultimate rate expected.

* A general description of the direction and pattern of the rate and when the ultimate rate will be reached.

To evaluate the health care trend rate assumption, consider its relationship to the Gross National Product (GNP). According to the Health Care Financing Administration, health care expenditures were 11.1% of GNP in 1987. Many feel that 20% of GNP is the maximum society will be willing to devote to health care. If GNP grows at a 2% real rate and medical inflation rises 4 percentage points faster than the consumer price index (CPI) for the next thirty years, by 2018 health expenditures would approximate 20% of GNP. During the period 1980-87, health care inflation averaged 3.5 percentage points more than the CPI.

Retiree Health Care Expense Volatility

Gains and losses from changes in the discount rate, health care cost trend rate and other assumptions are recognized only if they cumulatively exceed 10% of the obligation. FASB No. 87 has a similar provision for pension plans that is often referred to as the 10% "corridor". Even with this smoothing mechanism, retiree health care expense is likely to be more volatile than pension expense.

One reason is that retiree health care claims are more volatile than pension benefits. Even if the trend rate is unchanged, a sudden increase in claims cost means that the obligation is calculated off a higher base. The increase in the obligation itself does not have to be recognized immediately. However, such a change has indirect impacts on the expense calculation. For example, an increase in the obligation results in an increase in the current service and interest components of retiree health care expense.

Also, retiree health benefits are unfunded where most pension plans are funded. If a plan has no assets, gains and losses in the obligation from changing interest rates are not offset by opposite losses and gains on plan assets.

Finally, under the method used to allocate the cost to years of service, both service cost and interest cost increase as the work force ages, as it tends to do in mature industries. The cost increase due to this factor is roughly proportional to the change in the obligation. In a funded plan, interest on the fund assets would tend to offset this.

Transition Designed to Frustrate Analysts

When a company adopts a new accounting method, generally the financial statements are adjusted so that the balance sheet appears as it would had the new method always been in use. Normally, this is done by a charge or credit to income in the year the new accounting is adopted. For example, as companies adopt FASB No. 96, the new deferred tax accounting rule, many of them will report a credit to income labeled "cumulative effect of an accounting change."

FASB No. 87 was an exception. In the year of adoption, companies compute the difference between the fair value of pension assets and the projected benefit obligation. This difference, referred to as the "transition amount", is deferred and amortized to pension expense over the employees' average remaining service period, generally 15 years. Since most pension plans are overfunded, amortization of the transition asset reduces pension expense and in some cases creates pension "income" (ACCOUNTING ISSUES, July 17, 1990).

In the new Standard on retiree health care accounting, the Board gives companies the option of immediate recognition or amortization over twenty years. This will make company comparisons even more challenging.

Since retiree health plans are underfunded, companies electing immediate recognition will record a significant liability and a one time charge to earnings. The charge will be reflected on a separate line in the income statement and labeled "cumulative effect of an accounting change." Companies electing to amortize will increase retiree health care expense and reduce operating income each year for twenty years. The only way to find the amortization is to scrutinize the footnotes.

General Mills (GIS) and **Dayton Hudson** (DH) adopted the new accounting in anticipation of the FASB rule change. Both elected immediate recognition. General Mills adopted the new method in fiscal 1989, charging $116 million, pre-tax, to income. During the same year GIS booked a $314 million pre-tax extraordinary gain from the disposal of various specialty retailing segments. The net effect was a $99 million after-tax gain (ACCOUNTING ISSUES, May 3, 1990). Dayton Hudson adopted accrual accounting for retiree health care in the first quarter of 1990. This resulted in a $48 million charge to earnings. DH was able to offset this charge by simultaneously adopting FASB No. 96 on deferred taxes. That accounting rule change resulted in a $54 million benefit. Companies with similar one-time gains are the most likely to elect immediate recognition.

No Cash Flow Impacts and No Tax Deductions for Health Funds

There is no ERISA-like legislation governing postretirement health benefits. Thus, there is no law requiring companies to put money aside in a fund to pay for these benefits in the future. In addition, there are few tax incentives to do so. That is why most plans are totally unfunded. The FASB rule does not change this.

Some companies may wish to prefund this obligation to reduce the liability the FASB's new methodology creates. However, few tax efficient vehicles exist. Tax law allows companies to either:

> Establish a voluntary employee benefits association (VEBA) fund under section 501(c)(9) or,
>
> Set aside funds in a qualified pension plan under section 401(h).

However, these tax-advantaged funding options do not provide substantial encouragement to prefund.

Annual contributions to a VEBA are limited by a requirement that the cost of benefits for future retirees used to calculate the contribution be the same as the cost of benefits provided to current retirees. That is, no adjustment for medical cost inflation is allowed. In addition, investment earnings on funds held in VEBAs are subject to the unrelated business income tax.

Under section 401(h), a pension plan may provide for the payment of health expenses of retired employees and dependents through contributions to a separate account maintained under the plan. Medical benefits under the section must be subordinate to the plan's retirement benefits. Specifically nonpension contributions cannot exceed 25 percent of the aggregate contributions made to the pension plan.

The 25% limit does not permit contributions of a magnitude sufficient to fully fund health liabilities. This is especially true of companies with a high ratio of retirees to workers. Also, because many companies' pension plans are overfunded, allowable pension contributions are very low, even zero, thereby preventing tax deductible contributions for retiree health.

Excess Pension Funds Used to Pay Retiree Health Benefits

There is one bright spot. In the 1990 Budget Reconciliation Act, Congress provided that companies with excess assets in their pension funds may transfer them to a trust to pay retiree health care benefits (**ACCOUNTING ISSUES**, November 2, 1990).

There is a catch. To qualify, the transfer must meet the following conditions:

Pension plan assets cannot be reduced below the greater of 125% of current liability or projected benefit obligation, whichever is greater,

All participants in the pension plan immediately vest in 100% of their benefits,

Expenditures on retiree health expenses cannot be reduced for five years,

The transfer cannot solely benefit key employees, and

The government and affected employees must be given advance notice of the transfer.

These conditions make it unlikely many companies will take advantage of the provision. However, because this provision is a potential money maker for a revenue starved congress, we expect the conditions to be loosened or eliminated in future legislation.

ESOPs as a Funding Vehicle: Ralston and P&G

Two companies, **Ralston (RAL)** and **Proctor & Gamble (PG)**, are using an Employee Stock Ownership Plan (ESOP) as part of the solution to their retiree health care problem. An ESOP is a form of defined contribution pension plan that is funded with common or preferred stock of the sponsoring corporation.

During 1989, Ralston eliminated retiree medical care for current workers not within five years of retirement. They replaced the lost benefit with an ESOP. When they retire, workers will receive payments that can be spent as they wish. It can be used for health care, or if they are healthy, for a trip around the world.

Younger workers tend to favor this type of substitution. To receive retiree medical benefits, workers generally must be employed by a company providing them at retirement. An ESOP, however, vests sooner. After five years, the employee is entitled to the benefits earned to date.

The PG scheme is slightly more elaborate. PG is funding and providing retiree medical expenses through a $1 billion HSOP. An HSOP is a leveraged ESOP combined with a Section 401(h) retiree medical account. The Section 401(h) account is explained above.
The ESOP borrowed money which it used to purchase PG convertible preferred stock. The stock will be allocated to employee accounts over a period of years. At retirement, the

funds in the account will be used to provide medical benefits. Annual fixed contributions plus dividends on PG stock will be used by the ESOP to repay the loan.

The PG stock in the 401(h) account are retiree health care plan assets that offset PG's liability under the FASB rule.

The IRS and Treasury are looking at both the tax and health policy issues of this funding mechanism. If it holds up to scrutiny, other companies are likely to use it.

What Companies are Doing to Reduce Cost

As noted above, some companies are eliminating retirement health benefits for currently working employees and substituting other less costly and more easily controlled benefits. Others, like **McGraw Hill (MHP)**, are simply eliminating this benefit for those not eligible to retire.

Courts have sometimes allowed companies to cut benefits for current retirees or required them to share costs. Generally, however, companies have little ability to eliminate or amend plans for current retirees.

Recent legislation prohibits companies that file for bankruptcy from changing or terminating plans. The Retiree Benefits Bankruptcy Protection Act of 1988 prohibits companies that file chapter 11 from modifying retiree health plans unless the bankruptcy court orders such changes or the trustee in bankruptcy and retirees agree to such modifications. Otherwise, for current workers, a company can change the plan at any time.

The majority of companies are modifying their plans to shift more of the cost to retirees. Modifications include:

Indexing deductibles, co-payments or retiree contributions to the plan's claims experience or medical care component of the CPI,

Setting lifetime or annual benefit maximums, and

Basing benefits on years of service, annual pay at retirement or pension income.

It's Not Over

Back in 1988, we predicted that the final standard would be watered down, and it was. The transition period was extended from 15 to 20 years, the entire unfunded liability no longer needs to be recorded in 1997, and companies can base their estimates on the "substantive" plan rather than the written agreement.

The changes made, however, are not sufficient. Right or wrong, the Board stuck to its guns on many issues and in an uncharacteristic show of courage, the Board issued the final statement by a unanimous vote.

The real public uproar is still to come. Up to now, criticism has largely come from a small group of Fortune 500 companies. It is not until a standard is issued and companies begin to struggle with the actual implementation that the FASB gets inundated with complaints, requests for guidance and change. Statement No. 96 on deferred tax accounting is a perfect example of this phenomenon.

Even though this is a final standard, it can be changed. In fact, in the introduction to the 200 plus page Statement No. 106, the board acknowledges that "this Statement is not likely to be the final step in the evolution of more useful accounting for postretirement benefit arrangements." Possible future amendments include:

> Extending the period over which the liability must be accrued from the date of eligibility to the expected retirement date,
>
> Changing the discount rate from the current long-term rate on fixed income securities to a company specific cost of capital, and
>
> Delaying the effective date beyond the current 1993 deadline.

Delaying the effective date will not change the reported impacts of the accounting change, but it gives companies time to make changes to their plans that will. It also gives Congress an opportunity to address the social and economic problems of health care.

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CREDIT COMMENTS

RETIREE MEDICAL LIABILITIES AND FAS106

"OPEBs represent a substantial and growing burden for many companies."

A new statement recently issued by the Financial Accounting Standards Board (FASB)—"Employers' Accounting for Postretirement Benefits Other Than Pensions" (FAS106)—requires companies to treat retiree medical, life insurance, and other nonpension benefits (commonly referred to as OPEBs) as a form of deferred compensation. The benefits are to be accrued over the period that the employee renders the services necessary to earn them. Implementation of this accounting change is not expected to have any widespread impact on debt ratings, since cash flow will not be affected directly, and S&P already assesses the obligation to provide OPEBs when determining industrial companies' credit quality. Nonetheless, OPEBs represent a substantial and growing burden for many companies, which the new accounting will more clearly reveal.

ACCOUNTING TREATMENT

The standard accounting treatment until recently has been to use a cash (pay-as-you-go) basis, with no recognition of claims before they are incurred. Since 1984, companies have been required to disclose in a footnote the amount of current cash outlays, if available and material. Under the provisions of FAS106, companies will be required to record OPEBs on an accrual basis starting in 1993. The framework is very similar to pension accounting. However, there are several significant differences.

First, under FAS106, companies will not be required to book on the balance sheet any minimum amount of the total accumulated postretirement benefit obligation; rather, the balance sheet liability will increase gradually for most companies to the extent that the accrued expense (which consists partly of the amortization of unrecognized benefit costs) goes unfunded in the future. However, companies are allowed the option of recognizing the full liability immediately, which otherwise is to be reported only in a footnote. Some companies, including International Business Machines Corp., which recently announced a $2.3 billion after-tax charge to adopt FAS106, have already elected immediate recognition. Companies opting for immediate recognition will have increased total liabilities, decreased equity, and decreased future operating expenses relative to otherwise similar companies that choose the delayed recognition approach. Even companies that opt for immediate recognition, though, could have higher OPEB-related expense than previously, since companies will still have to recognize the current cost of benefits attributable to current service, as well as interest expense on the obligation.

Another important difference with pension accounting will be the level of confidence that can be placed in the disclosed liability and expense amounts. FAS106 requires the same types of assumptions about employee turnover, retirement age, mortality, dependency status, and discount rate used in pension accounting. However, FAS106 will also entail the use of additional, speculative assumptions about changes in health-care costs, taking into account such considerations as changes in health-care inflation, health-care utilization or delivery patterns, medical technology, and the status of plan participants. Reported OPEB liability and expense amounts will be highly sensitive to differences in the underlying assumptions.

ANALYTICAL APPROACHES

FAS106 should result in disclosures that will be useful in gauging the magnitude of OPEB obligations by serving as a "red flag" identifying possible instances where the OPEB liability is more onerous than previously supposed. Conceivably, FAS106 could also reveal instances where a company is significantly less burdened by OPEBs than previously assumed. However, for full or in-depth balance sheet analysis, S&P will not rely on any single figure to represent the OPEB obligations. Given uncertainties inherent in estimating such a figure, it is preferable to consider several alternative estimates. As in the case of other indeterminate contingencies, such sensitivity analysis is viewed as the best approach. Among the footnote disclosures required by FAS106 is additional information that should be helpful in performing sensitivity analysis.

Still, in most cases, for purposes of conventional financial ratio analysis, S&P's debt rating staff will rely mainly on financial statements adjusted to a pre-FAS106 basis. This will be necessary to avoid the inconsistencies in both historical analyses and intercompany comparisons that otherwise would result. Specifically, where companies opt for immediate recognition, S&P will reverse the impact on the affected liability and equity accounts. The same balance sheet adjustments will be made eventually for companies choosing the deferred recognition approach once the accrued balance sheet liability becomes material. Where material, reported operating earnings will be adjusted for the noncash portion of OPEB expense in calculating profitability ratios. S&P's ability to make this income statement adjustment will depend on continued access to data on cash outlays. Since, under FAS106, companies will no longer be re- ▸

quired to disclose cash outlays, S&P may request this information directly from issuers, just as Employee Retirement Income Security Act (ERISA)-mandated pension fund contribution schedules are now sought in certain cases.

In further assessing the significance of a company's OPEB obligations, S&P will focus on current and prospective cash outlays as a component of cost position. A company burdened by particularly heavy retiree medical costs should be penalized in its competitive assessment, much as firms are penalized for having older-than-average plants. By calculating ratios of a company's cash outlays to sales, operating earnings, and operating cash flow for a given year, and considering the trend of the ratios over several years, one can get a sense of the problem's magnitude and compare a firm with industry peers.

Industries most affected by OPEBs*

Industry	Cash outlays % sales	Cash outlays % oper. inc.	Cash outlays % oper. cash flow
Steel-integrated	1.1	20.8	15.7
Automotive-OEMs	0.6	1.4	83.6
Aerospace & defense	0.4	9.2	39.7
Electrical equipment	0.3	2.6	3.9
Machinery	0.3	5.5	2.1
Metals-nonferrous	0.2	1.5	1.5
Automotive parts producers	0.2	3.9	3.2
Health-care products	0.2	1.3	1.7
Capital componentry	0.2	2.5	2.9
Chemical companies	0.2	(4.5)	2.9
Apparel	0.1	1.5	(0.2)
Appliances	0.1	0.0	(12.2)
Gas	0.1	1.4	52.5
Steel-nonintegrated	0.1	1.2	1.1
Packaged & branded food	0.1	0.7	0.9

*Based on average reported cash outlays, 1987-1989, with industry averages adjusted for outliers. Industries are ranked according to OPEB as a percent of sales.

"A company burdened by particularly heavy retiree medical costs should be penalized in its competitive assessment."

Using these measures, S&P has performed a survey of all rated domestic industrials, calculating company and industry averages for the period 1987-1989 *(see table)*. Results of this survey indicate that companies with the heaviest OPEB-related cash outlays generally are those that have a high ratio of retirees to active employees because of downsizing or other reasons; are labor intensive; or offer employees particularly generous benefits. The steel, auto, and other capital goods and natural resource industry groups—where many companies have a combination of all these attributes—clearly have the largest concentration of problem cases. However, the extent of the burden is not necessarily uniform within specific industry groups. For example, whereas a number of paper and forest products companies have relatively heavy OPEB expense, others have cash outlays not even material enough to be reported. Outside of companies in the typical "smokestack" industry groups—such as the apparel, health-care products, and newspaper industries—there are isolated instances of companies which, due to particular circumstances, are far more burdened than direct competitors.

Where retiree medical obligations represent a very substantial use of cash, S&P will seek more specific information about a company's work force and retiree population makeup and insurance plan characteristics to gain a better understanding of the likely direction of future cash outlays. S&P will also pay close attention to management's cost-cutting strategies. Although the Financial Accounting Standards Board has no intention of regulating retiree benefit plans, its initiative to modify the financial accounting for such plans is focusing managements' attention on the need for more aggressive actions to contain costs. However, efforts to reduce post-employment benefits offered to existing employees might have an adverse impact on productivity, limiting the extent of true savings to be realized. Moreover, while much litigation continues on the issue, it appears that management has very limited flexibility to modify benefits offered to existing retirees, unless the right to do so has been explicitly provided for in plan documentation. Prospects for significant legislative relief in the form of a broadened national health insurance system appear remote.

Apart from limiting costs, some companies may seek to minimize the impact of FAS106 on financial reporting by funding their OPEB obligations. Under FAS106, plan assets and related investment earnings reduce the liability and expense, respectively, for reporting purposes, if the fund is segregated (usually in a trust), like pension funds. However, existing tax-advantaged vehicles for funding OPEB plans—including 401(h) plans and voluntary employees' beneficiary associations—are limited in their applicability. In the wake of a recent transaction by Procter & Gamble Co., it appears likely that the IRS will limit future use of employee stock ownership plans to provide OPEB benefits. Thus, widespread funding of OPEB obligations is not expected to occur. For analytic purposes, funded OPEB obligations are regarded as effectively offset, although the extent of the offset can vary with plan investment performance. However, in considering the effect of funding on a company's financial condition, S&P will also take account of the impact on financial flexibility, given that plan assets are not easily reverted.

Adoption of FAS106 could put some companies in technical violation of covenants contained in credit agreements, or limit their ability to incur new debt. However, in light of the long lead time companies will have before they are required to adopt FAS106, S&P anticipates that most, if not all, affected companies should be able to resolve problems concerning financial covenants without any impact on ratings. *Dmitri Nayduch, Scott Dinsdale, and A.J. Santos provided statistical research for this article.*

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APPENDIX 6A

Legal Definitions of PBOPs

Utility Contracts and Employee Handbooks

SOUTHERN CALIFORNIA EDISON COMPANY

OII 90-07-037 (PBOPs)

CPUC DATA REQUESTS - DATA REQUEST NO. 12

Dated 4/23/91

Q. II. For each and every PBOPs currently provided to SCE retirees, provide its earnings formulae and a complete citation for the employee/retiree handbooks where these earnings formulae are officially and explicitly set forth. If a PBOP does not have any published earnings formulae, then state that no such formulae exist. If you have not already provided DRA with a complete copy of the current retiree handbook then do so as part of your response to this request for information.

A. II. No such earnings formulae exist for SCE's PBOP plans for retirees.

SOUTHERN CALIFORNIA EDISON COMPANY

OII 90-07-037 (PBOPs)

CPUC DATA REQUESTS - DATA REQUEST NO. 12

Dated 4/23/91

Q. III. For each and every PBOPs currently provided to SCE retirees, provide a complete copy of the section in the benefit contract which sets forth the employer's legal ability to terminate or reduce PBOPs.
If you have not already provided DRA with a complete copy of the current retiree handbook then do so as part of your response to this request for information.

A. III. For a general description of SCE's power to amend its PBOP plans for retirees, please refer to Page 186 of the Retiree Benefits Handbook. For a description of SCE's ability to amend its medical plans for retirees, please refer to the attached Article 14 (Primecare) and Article 16 (Healthflex) of the Plan documents.