Grandfathering. It's not surprising, then, that most of the survey participants are acutely aware of the cost implications of FAS 106 and are implementing — or planning/considering — actions to reduce expense. And what to do about benefits for current retirees will figure prominently among the critical issues they'll have to address. In fact, some employers who previously decided to grandfather current retirees when making plan changes may have to take another look at benefits for this group.

(Note: An article discussing benefit changes for current retirees appeared in the January/February issue of Towers Perrin *Monitor*. See page 9 for details.)

Sizing Up the Cost

Most of the survey companies have taken steps to measure their retiree welfare liabilities under FAS 106. Efforts in this area should nevertheless continue in 1992, as employers who have not yet valued — or valued before the accounting standard was finalized — prepare for the 1993 adoption deadline.

In a November 1989 Towers Perrin survey, only 59% of the responding companies had completed an actuarial valuation of their retiree welfare benefits. Our new survey shows significant progress — most of the participants (80%) completed a valuation at some point during the past three years.

Nevertheless, a significant percentage of the group (20%) has yet to measure the impact of accrual accounting. It's also worth noting that only about half of the companies (54%) valued their liabilities in 1991 when final details of the new standard were available. The remaining employers who have measured costs under accrual accounting (26%) conducted their valuations before the final standard was released in December 1990.

Pinning down the numbers. Although valuations under earlier versions of FAS 106 would produce results in the same order of magnitude, employers who haven't valued under the final standard will want more precise figures as the deadline approaches and the need for comprehensive benefit design and expensing strategies increases.

Moreover, employers who have experienced significant workforce changes — due to downsizing, acquisitions, divestitures and so forth — will also need a valuation that more precisely reflects current demographics.

Taking inventory. Finally, all employers will want to take a full inventory of their retiree welfare commitments to ensure that benefits that might be overlooked — or considered "insignificant" in cost terms — are factored into the expense calculations. Such items might include pre-65-only plans and retiree-pay-all plans that are underpriced.

Cost measures that are both accurate and thorough are particularly important for employers who are considering adopting FAS 106 in 1992, or want to keep open the option to do so.

Financial Implications

For many companies, the financial impact of retiree welfare liabilities will be significant — both in terms of cost as a percentage of payroll and expense as a charge against pretax earnings. Employers who recognize the transition obligation as a onetime charge will also see a substantial reduction in net worth.

While the impact of FAS 106 varies widely based on plan design, employee demographics and other factors, the new standard will in most cases produce dramatic cost increases from pay-as-you-go levels.

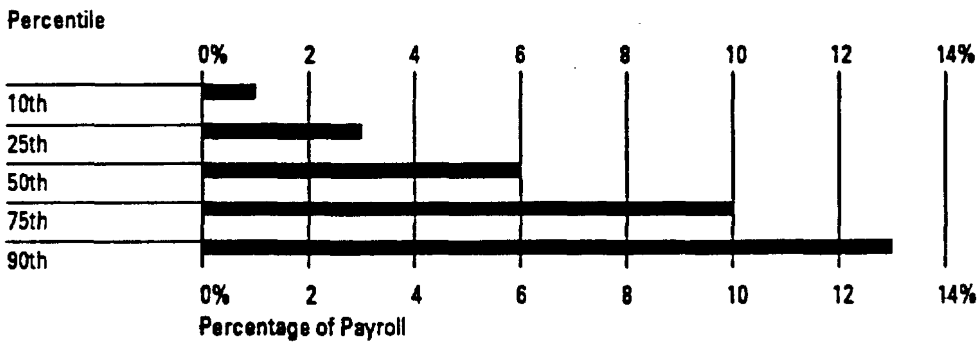
For example, pay-as-you-go retiree welfare costs for a typical company generally range from 1% to 3% of payroll. By contrast, companies at the median of our survey group report FAS 106 expense at 6% of payroll — the average for the group is 7%. Notably, one in four respondents reports FAS 106 expense at 10% of payroll or higher. (See *Exhibit 2.*)

MEDBase, a Towers Perrin database of client valuations, shows similar expense results. For employers at the median of a 147-company *MEDBase* sample, 1991 annual costs per active employee would jump from $475 on a pay-as-you-go basis to $2,360 under FAS 106 — a more than fivefold increase. (See page 9 for information on *MEDBase.*)

Bottom-line impact. Expense levels reported by our *Fortune* 1000 group translate into an average annual reduction in corporate pretax earnings of 17%. Companies at the 50th percentile report earnings reductions of 10%. Notably, one-quarter of the respondents report reductions of 20% or more. (See *Exhibit 3.*) Two companies in the survey group reported that FAS 106 expense would cut reported earnings to zero.

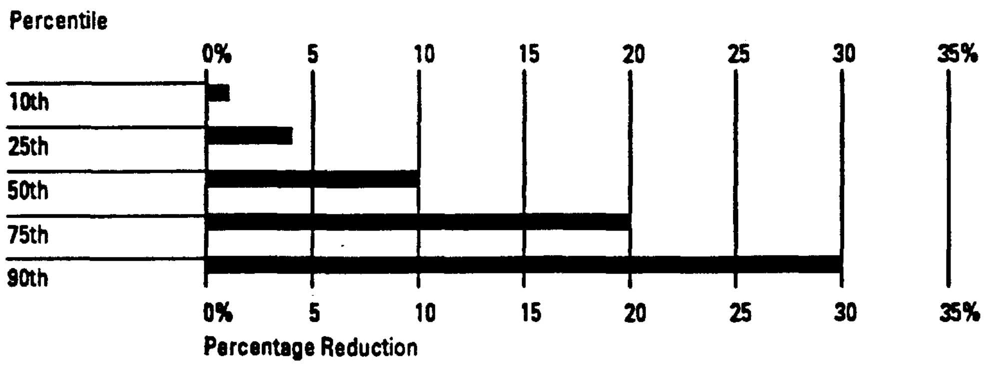
Although one might expect that large companies would show a greater impact (due to richer benefit plans, relatively larger retired populations or other factors), this isn't the case according to the survey results. Both large and small employers in the survey group face the same range of earnings reductions and the same overall average reduction.

Exhibit 2: FAS 106 Expense as a Percentage of Payroll*



*The average for the survey group is 7%.

Exhibit 3: Percentage Reduction in Pretax Earnings**



**The average for the survey group is 17%.

We also asked the survey group what the reduction in net worth would be if the company recognized the initial transition obligation as a onetime charge. The average reported reduction in net worth was 13% — with about a third of the respondents reporting reductions of less than 7% and another third reporting reductions of more than 20%.

The effects of inflation. In our November 1989 survey, the average reported reduction in earnings was substantially lower — 10% compared with the current average of 17%. Similarly, the earlier survey showed an average reduction in net worth of 9% (compared with the current 13%) if companies recognized the transition as a onetime charge.

Clearly, double-digit health care cost inflation (or "trend") in the late 1980s is one factor that has magnified the impact of FAS 106. However, many companies are now beginning to see a slowdown in annual benefit cost growth. As a result, those taking a strategic approach to FAS 106 expense are beginning to use more optimistic long-term trend assumptions in valuing their liabilities.

Our *MEDBase* data confirm this observation. In the 1991 valuations, for example, nearly 80% of the *MEDBase* companies assumed ultimate medical cost inflation at a rate of 7% or less, while only 36% in the 1990 sample were as optimistic.

Management tolerance — the real "bottom line." When all is said and done, management will draw the bottom line on FAS 106 expense — i.e., an "acceptable" level of profit reductions given a variety of key financial factors, such as the current condition of the company's balance sheet and income statement, as well as the expectations of shareholders and other investors.

An earlier Towers Perrin survey of *Fortune* 1000 CFOs (*FAS 106: The View From the CFO's Office;* July 1991) suggests that results reported in our current survey may exceed what corporate management will tolerate.

In the CFO survey, about 50% of the respondents said they would accept earnings reductions of only 9% or less — well below the 17% average reported by our current group. So it appears that expensing decisions, benefit design changes and other actions to reduce costs may still lie ahead for the survey companies.

Expensing Strategy

Given the magnitude of FAS 106 expense, it's not surprising that few companies are currently accruing and few are prefunding the liability. The survey suggests, however, that a significant number of employers will adopt FAS 106 in 1992, so interest in expensing and funding issues is likely to increase this year.

Although FAS 106 is an "objective" standard, it does give employers considerable discretion in determining:

- when to adopt the new rules (i.e., if adoption before the deadline makes sense)
- how to adopt (i.e., whether to recognize the transition obligation attributable to past employee service)
- what assumptions to use in measuring liabilities and reporting expense (e.g., discount rates and medical trend, as discussed above).

These policy decisions will, in turn, have a significant effect on the company's financial position — and will depend in large part on the company's current situation, future outlook and other business factors.

Early adoption, funding. Since FAS 106 expense will be significant for most companies, an early transition to the rules generally makes sense only in special circumstances. For example, companies that have had a particularly good business cycle — or a particularly bad one — might consider "packaging" FAS 106 expense with other nonrecurring financial events.

Special situations like these undoubtedly came into play for the few companies in our survey (12%) who said they have already booked part of the FAS 106 liability, as well as for those who said there was some or high likelihood that they would adopt the new standard for the 1991 fiscal year (only 20% of the respondents).

Similarly, just under 10% said they have already funded part of the liability. Those few who are funding have, on average, funded only 22% of the cost. Contrary to what might be expected, however, survey respondents who are funding represent a cross section of industries. Only about a third are utilities and defense contractors who might have the opportunity to pass the costs along to customers.

It's also worth noting that our 1989 survey (cited earlier) showed about the same prevalence of early accruals and funding. So despite interest and discussion, the last few years have seen little movement in these areas.

The expensing picture is about to change dramatically, however. According to the survey, quite a few companies will make the move to FAS 106 in 1992. One in four said there is a high chance that they'll adopt the new accounting standards this year, and an additional 42% said there is some chance that they'll adopt early. Interest in prefunding as an expense reduction measure may therefore increase as more companies confront their costs.

How to adopt. The immediate recognition vs. amortization question is one of the key strategic issues employers face under FAS 106. Among our survey respondents, just over a quarter (27%) said there is high likelihood that they'll recognize the transition obligation as a onetime charge, and an additional 39% said there is some likelihood. This response squares with our earlier survey of *Fortune* 1000 CFOs, where over half of the respondents indicated that their companies were very or somewhat likely to take the charge upfront.

The immediate recognition approach is attractive because shareholders, investors and other key constituents might be inclined to discount a large onetime expense, and would react favorably to the resulting reduction in future annual expense. For most companies, annual per employee costs would be about 30% less in future years if the transition amount is immediately charged.

Our survey results indicate that timing nevertheless remains a strategic issue: employers who intend to take the charge immediately also intend to adopt FAS 106 this year, slightly in advance of the deadline. Among the survey companies planning to wait until 1993 to adopt, most will *amortize* the transition obligation.

Evaluating Benefit Design

Many of the survey companies are taking (or planning) action to reduce liabilities by modifying plan design. For example, nearly three-quarters have already increased retiree contributions or are planning/considering increases. Few have terminated their plans or moved to a retiree-pay-all design.

As employers confront retiree welfare costs and related reporting issues, many are reviewing their current benefit programs and redesigning their plans. Part of that effort should involve an assessment of the total retirement package, including retirement income programs as well as welfare benefits.

Are benefit dollars allocated efficiently — and fairly? Does the total program support business and human resource objectives? How well will employer- and government-provided benefits meet future retiree needs, and how much responsibility should employees take in preparing for retirement?

In this context, plan design evaluation should address eligibility requirements and cost-sharing provisions, including contributions, coinsurance and deductibles. Related issues include how the plan integrates with Medicare, how it shares inflation risk with retirees and how well the design provides for long-term management control over costs. The survey results show that employers are taking action in several key areas.

Eligibility. Just under one-quarter (23%) of the survey companies have tightened the eligibility requirements for future retirees under the health plan. (New eligibility rules might, for example, include specific age/service requirements.) More than a third (37%) are planning/considering such a change. (See *Exhibit 4.*)

Contributions. The majority (73%) of the total survey group have either already increased

Exhibit 4: Controlling Costs by Design

Health Plan Design Changes	Implemented for Current Retirees* (% Employers)	Implemented for Future Retirees* (% Employers)	Plan to Implement (% Employers)	Changes Under Consideration (% Employers)
Eligibility rules:				
■ Tightened for employees/retirees	4%	23%	16%	21%
■ Tightened for spouse/dependents	4	17	12	17
Employee/retiree contributions:				
■ Increased or applied for first time	28	37	19	14
■ Varying by length of service	6	23	17	22
Limit employer contribution to a defined dollar amount	7	18	11	18
Termination:				
■ Terminated coverage	3	5	3	5
■ Continued coverage but now retiree-pay-all	3	5	3	7
Utilization controls (preadmission, second opinion, etc.):				
■ Established or strengthened	25	19	7	7
Managed care:				
■ Established or expanded preferred provider arrangements	17	15	5	11
■ Established or expanded managed care program	17	16	9	12
Flexible benefits for retirees	4	8	5	8

*Some employers responded in both categories.

contributions — for current and/or future retirees — or are planning/considering increases. (Since some employers have implemented changes for *both* current and future retirees, the percentages shown in Exhibit 4 add up to more than 73%.) Among companies with 10,000 or more employees, the percentage reporting increases is slightly higher (80%).

Since health benefits account for most of the FAS 106 liability, most employers in our survey are focusing on those plans. Nevertheless, a few are looking at other retiree welfare benefits. For example, just under 20% of the survey companies indicate that they have already reduced or eliminated retiree life insurance benefits or have plans to do so.

Tying benefits to service. Borrowing concepts from their pension plans, many employers are taking a hard look at medical benefit costs for early retirees (who are not yet eligible for Medicare) and those retiring with relatively short service.

These costs can be considerable. At a typical company, for example, the value of medical benefits for an employee retiring at age 55 with 10 years of service is *more than twice* the value of the pension benefit at age 55 — and more than twice the value of medical benefits the retiree would receive at age 65.

So in addition to age- and service-related eligibility requirements, cost-control measures might include pension-style approaches to *benefit levels* — e.g., setting the company share for each future retiree at a specific percentage of plan cost, multiplied by years of service.

About half of the employers in our survey who have increased contributions for future retirees have implemented service-related contributions. Similarly, about half the companies planning an increase are considering pegging contributions to service.

'Defined dollar' benefits. Another cost-sharing technique is to set a specific limit on employer contributions — either a flat dollar amount for all retirees or an amount based on years of service at retirement. And while the effects of various plan changes will vary from company to company, a defined dollar cap on the employer's share of the premium produces the greatest impact in most cases.

For example, a Towers Perrin analysis (see the May 1991 issue of *Monitor*) shows that this approach would reduce FAS 106 expense for a typical company by as much as 68%. (By contrast, gearing employer contributions to service would reduce the sample company's expense by 10%.)

So far, only a few of our survey companies (7%) have imposed specific caps on contributions for current retirees. However, more than twice as many (18%) have taken this approach to contributions for future retirees, and an additional 29% are planning/considering a cap for future retirees.

Terminations/retiree-pay-all designs. Despite the cost burden, few companies in the survey are terminating their retiree medical plans or moving to a retiree-pay-all design. Only 6% have terminated coverage or converted to retiree-pay-all for current retirees; about 10% have taken this approach for future retirees. Another 12% of the survey companies are planning/considering such changes. (Note that some employers are planning/considering both alternatives. The breakdown shown in Exhibit 4 reflects this overlap.)

It's also worth noting that employers who have terminated their plans or converted to retiree-pay-all represent a broad cross section of industries. Contrary to what one might expect, these approaches are not confined to industries with relatively high turnover and high concentrations of low-paid employees (such as retail and banking).

Other Approaches

A significant number of companies have implemented or are planning some form of managed care for retirees. Flex for retirees is currently less prevalent.

As with medical benefits for active employees, many employers are discovering that sharing more costs with retirees is an effective approach — but only up to the point where benefit adequacy is at stake. So some are exploring the possibility of using other cost-control techniques in their retiree plans, such as managed care and flexible benefits.

Although not specifically covered in our survey, employers should also consider managed prescription drug programs for retirees (since Medicare doesn't cover outpatient drug costs), as well as the feasibility of using HMOs that offer Medicare risk contracts.

Managed care. Implementing managed care for retirees is by no means a simple matter — since many retirees eventually move away from their former employment locations. And unless carefully designed, some managed care arrangements may prove less effective in reducing retiree health costs because of the way employer benefits integrate with Medicare.

Nevertheless, a significant number of our survey companies are attempting to meet these challenges. Just under a quarter (24%) have established preferred provider arrangements or some form of managed care for current retirees. About the same percentage have applied this cost-control strategy to benefits for future retirees. An additional 25% are planning/considering similar changes. (Exhibit 4 shows a breakdown of the survey responses in these areas. Some companies responded in more than one category.)

Flexible benefits. Flex plans for retirees are less prevalent, probably due to administrative considerations. Less than 10% of the survey companies have implemented flex for retirees, although another 13% of the survey companies are planning or considering it. (Quite a few more of the survey companies have flex for actives.)

Benefit Communication

Many employers are supporting their cost-control strategies with changes in the way they communicate retiree welfare benefits.

More than half of the survey companies (55%) have taken some steps to change the way they communicate retiree welfare benefits. The majority of those who have modified communication (83%) are emphasizing the company's right to modify the plan.

This message is critical in protecting employers in the event of litigation. Since ERISA doesn't require vesting for retiree welfare benefits, the courts will look to SPDs and other employee communications to determine whether an employer has promised lifetime benefits without change.

Just about as many of the survey companies are emphasizing the shared responsibility between retirees and the employer in paying the cost of health care. And about 60% have modified their communications in an effort to promote cost-effective use of health care.

What's Ahead

Although our survey results suggest that employers are taking actions on several fronts to manage costs under FAS 106, the relatively high average earnings reduction reported by the survey companies indicates that the "final word" on expense and plan design issues is yet to come.

For more information about how Towers Perrin is helping employers address these issues, please contact the Towers Perrin office in your area. If you'd like copies of our *MEDbase* report or back issues of *Monitor,* please call your local Towers Perrin office or 1-800-525-6741.

FAS 106 Survey Participants*

AAA Michigan
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American General Corp.
American Information Technologies Corp.
American Savings Bank
Arco Financial Services
Arkla Inc.
Arizona Public Service Company
Automobile Club of Southern California
The BFGoodrich Co.
BHP Petroleum (Americas), Inc.
Baker Hughes Inc.
Ball Corp.
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Toyota Motor Sales, U.S.A., Inc.
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Travelers Corp.
USG Corp.
Union Carbide Corporation
Universal Foods Corporation
Valeo Engine Cooling, Inc.
Wang Laboratories Inc.
Whittaker Corporation
Williams International Corp.
Xerox Corp.

* The 125 companies listed here agreed to allow Towers Perrin to release their names as survey participants. The total survey group included 150 companies.