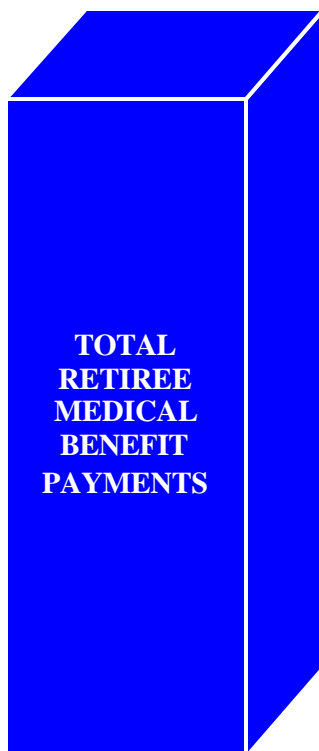


## **RETIREE HEALTH (FAS #106) ACTUARIAL EXPENSE PROCESS**

Harbridge Consulting Group's method for valuing an employer's retiree health benefit obligation and expense is summarized below:

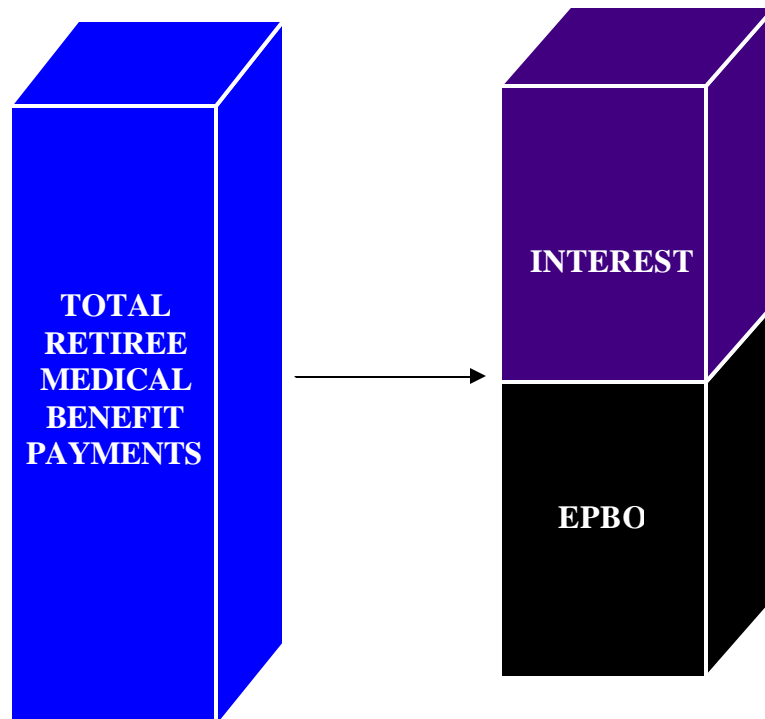


- I. Total Retiree Medical Benefit Payments are determined by the following:
- Plan Participants as of the valuation date (current retirees/spouses and future retirees/spouses)
  - Plan Provisions
  - Medicare Integration
  - Future Events (estimated by actuarial assumptions)
    - Retirement
    - Mortality
    - Withdrawal
    - Disability
    - Medical Inflation

The above bar graph represents all the retiree medical benefit payments that will be paid by the employer to all current and future retirees and their spouses. SFAS No. 106 requires that the amounts represented by this bar graph be expensed over the working career of active employees. To explain the actuarial expense process, we divide the bar graph to show the various liabilities and then allocate portions of these liabilities to develop the annual accrual expense under SFAS No. 106.

II. Total Retiree Medical Benefit Payments are split into two components:

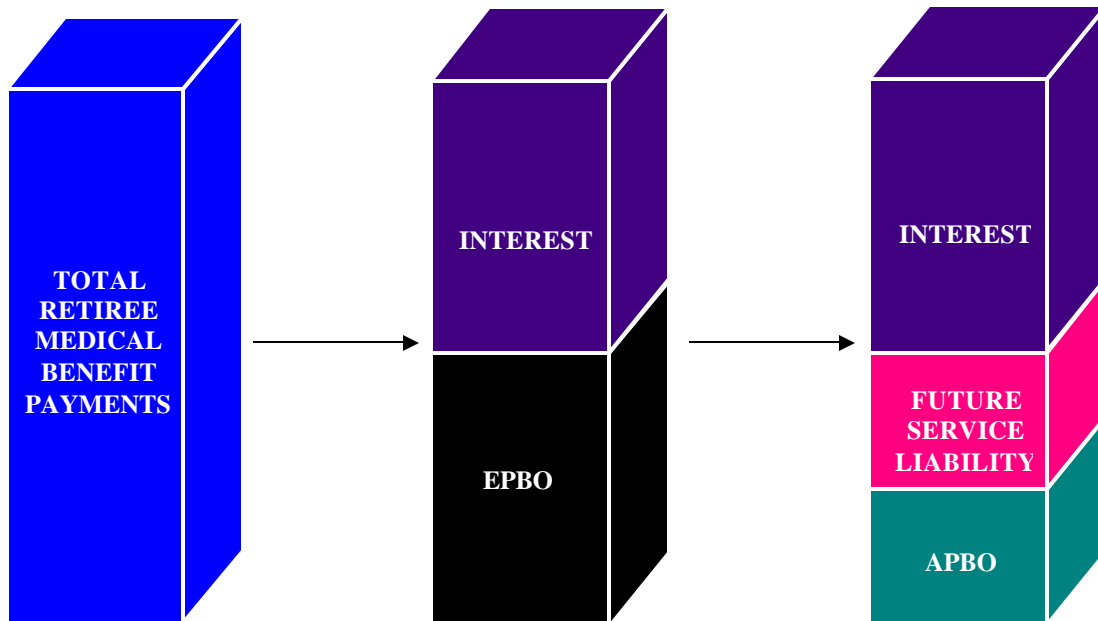
- Interest
- Expected Postretirement Benefit Obligation (EPBO)



The EPBO represents the amount that would need to be invested at the valuation date to grow with interest into the amount required to pay the total retiree medical benefit payments.

III. Expected Postretirement Benefit Obligation is split into two components:

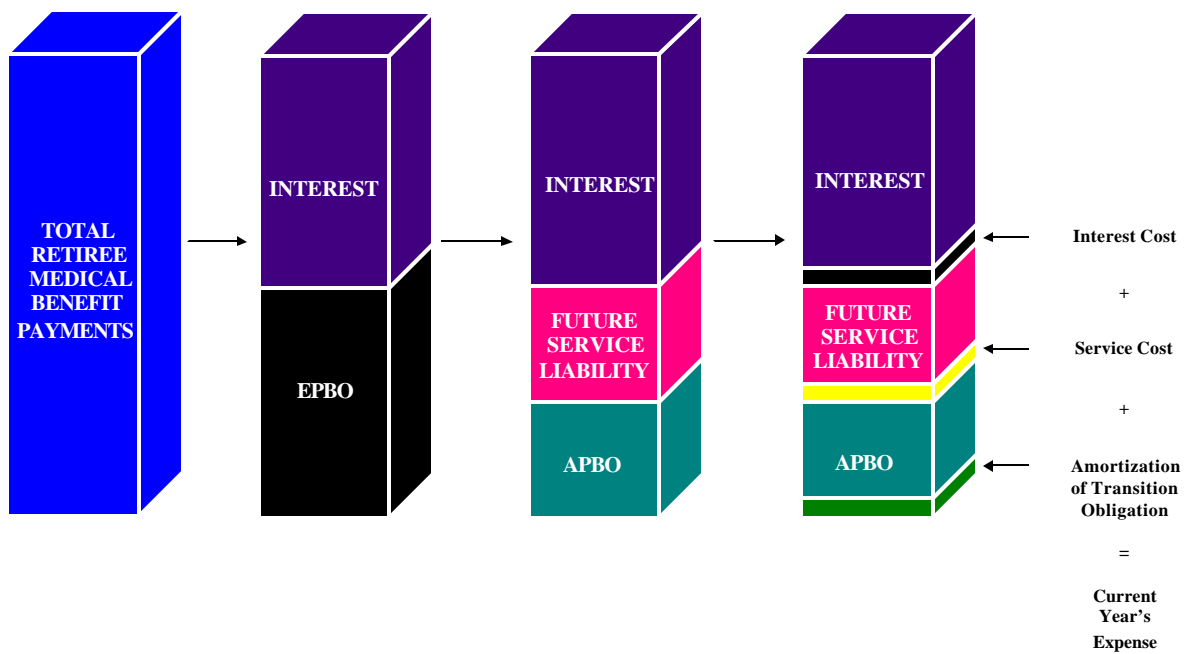
- Liability for service prior to the valuation date (APBO).
- Liability for service subsequent to the valuation date (Future Service Liability).



The Allocation of EPBO between APBO and Future Service Liability is determined by a benefit/years-of-service approach as required under SFAS No. 106.

IV. Annual Accrual Expense (in year of adoption) is comprised of:

- Interest Cost
- Service Cost
- Amortization of Transition Obligation



As depicted in the above bar graph, a portion of the interest, future service liability, and Transition Obligation must be accrued. The Transition Obligation is the APBO adjusted for any assets and existing accruals as of the date of adoption of SFAS No. 106. If the Transition Obligation is immediately recognized, then current year's expense in year of adoption would equal the interest cost and service cost plus the entire Transition Obligation.

- V. In subsequent years, the annual accrual expense will change due to experience adjustments and actuarial assumption changes (gains and losses), plan amendments, special termination benefits, curtailments, and settlements.

Therefore, the annual accrual expense in subsequent years would be the following:

$$\begin{array}{l} \text{ACCRUAL EXPENSE} = \\ \text{Interest Cost} \\ + \\ \text{Service Cost} \\ + \\ \text{Amortization of Transition Obligation} \\ + \\ \text{Amortization of Gains/Losses} \\ + \\ \text{Amortization of Unrecognized Prior} \\ \text{Service Cost} \\ \text{(Plan Amendments)} \end{array}$$

Additionally, special termination benefits, curtailments, and settlements, if they occur, will result in a one time adjustment to the annual accrual expense.

## SUMMARY OF SFAS NO. 106

### **Introduction**

On December 21, 1990, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 106 (SFAS No. 106 or the Standard), **Employers' Accounting for Postretirement Benefits Other Than Pensions**. SFAS No. 106 requires employers to accrue the cost of retiree health and other postretirement benefits during the working careers of active employees, starting no later than fiscal years beginning after December 15, 1992 (i.e., the first quarter of fiscal 1993). For nonpublic employers with up to 500 plan participants and foreign plans, the new Standard is effective for fiscal years beginning after December 15, 1994.

This Section summarizes the important provisions contained in SFAS No. 106.

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### **Accrual Accounting**

Pay-as-you-go (cash basis) and terminal accrual (accrue at retirement) approaches will no longer be acceptable. The FASB believes that retiree health care, life insurance and other post-retirement benefits are forms of deferred compensation earned through employee service, and therefore, should be accrued while an employee works for the employer.

The Standard applies to employers providing postretirement benefits (such as health care, life insurance or housing allowance) to current and future retirees and their dependents. Other postemployment benefits, such as severance pay or wage continuation to disabled or terminated employees, generally are not covered by this Standard. These benefits are accounted for under SFAS No. 112. Although the Standard applies to a wide range of benefits offered to retirees, this summary focuses on retiree health benefits because they are the most complex and difficult to measure.

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## **Full Eligibility**

In the FASB's view, the present value of postretirement benefits should be fully accrued by the date the employee is fully eligible to receive benefits based on the terms of the plan (the "full eligibility date"), because further employee service need not be performed in order to receive full benefits. In most cases, eligibility for retiree health benefits is based on eligibility for immediate pension benefits, which is usually related to a combination of age and years of service (e.g., age 55 and 10 years of service).

Following this concept, the FASB approach to measurement focuses on three groups:

- retirees and dependents receiving benefits;
- active employees fully eligible for benefits (e.g., those eligible active employees age 55 with at least 10 years of service who have not yet retired); and
- active employees not yet eligible (e.g., those under age 55).

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## **Defining the Obligation**

In defining the obligation for postretirement benefits, the FASB has maintained certain concepts similar to pension accounting but has introduced new and modified terms designed specifically for postretirement benefits.

**Expected Postretirement Benefit Obligation (EPBO)**--The EPBO is the actuarial present value as of the measurement date of all benefits expected to be paid after retirement to employees and their dependents. It includes the APBO plus the actuarial present value of expected future service costs of active employees who have not yet reached the full eligibility date. This amount is not required to be recorded or disclosed on the financial statements, but is referred to in the measurement process.

**Accumulated Postretirement Benefit Obligation (APBO)**--The APBO is the actuarial present value of future benefits based on employees' service rendered to the measurement date. The APBO is equal to the EPBO for retirees and active employees fully eligible for benefits. Prior to the date an employee attains full eligibility, the APBO is a portion of the EPBO. The only difference between the APBO and the EPBO is the future service costs of active employees not yet fully eligible.

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## **Attribution**

A single measurement approach is required to spread costs over accounting periods (the FASB refers to this as "attribution"). The Standard specifies both the method of spreading costs and the period over which the costs will be spread, as follows.

### **Attribution Method**

A benefit-years-of-service approach (i.e., the projected unit credit actuarial cost method) will be used to spread costs over accounting periods. Because the FASB found no compelling reason to switch from the approach used in pension accounting, it rejected the use of other actuarial approaches, including those under which costs are spread as a percentage of pay.

### **Attribution Period**

The beginning of the attribution period is the employee's date of hire--unless the plan grants credit only for service from a later date and that credited service period is not nominal in relation to employees' total years of service prior to full eligibility. Although "nominal" is not defined in the Standard, Appendix C to SFAS No. 106 provides an illustrative example. In that example, the plan could define the credited service period as one year when 100% benefit coverage is only granted in the year in which an employee reaches age 60. If employees are expected to have rendered an average of 20 years of service by age 60, the credited service period of one year is therefore nominal in relation to the total years of service. In this example, the service cost is recognized from the date of hire to age 60. In actual employer situations, however, much more judgment will be needed to ascertain whether the credited service period is nominal.

The end of the attribution period is the full eligibility date. Costs will generally be spread ratably from the beginning of the attribution period to the end of the attribution period, unless the plan specifies a benefit formula tying benefits to years of service, which meets the definition of "front-loaded" in the Standard. This provision of the Standard requires that in situations in which the plan's benefit formula attributes a disproportionate share of the EPBO to employees' early years of service, costs should be spread according to the plan's benefit formula. However, the Standard does not define "disproportionate."

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## **The Substantive Plan**

In what may be the most important change to the Exposure Draft, the FASB will base the accounting on the "substantive plan," not just the written plan terms. Under this new approach, employers will be required to assume that the written plan will be changed in the future with respect to certain cost-sharing provisions (e.g., deductibles, retiree contributions, plan maximums) if certain conditions are met. Applying the substantive plan concept is likely to significantly impact obligations and expense under SFAS No. 106.

Some of the key factors in evaluating the substantive plan include determining whether:

- The employer has a past practice of maintaining a consistent level of cost sharing or a consistent approach to increasing or decreasing the cost-sharing provisions of the plan; or
- In cases where a past practice of cost-sharing changes does not exist--or if the employer intends to modify its past practice--the employer has the ability, and has communicated its intent to the affected plan participants, to institute different cost-sharing provisions at a specified time or when certain conditions exist.
- If an employer has a plan subject to collective bargaining, the FASB has concluded that it may be more difficult for an employer to meet the criteria of a substantive plan because the employer may not have the unilateral right to amend the terms of the written plan. However, anticipation of future changes to a union-negotiated plan is not specifically prohibited under the Standard, provided the employer meets the conditions set forth in the Standard.
- Changes in the benefits, other than benefits defined in terms of monetary amounts, covered by postretirement health care or other post-retirement benefit plans, are not anticipated.

In addition, the Standard requires that "the effect of a decision to temporarily deviate from the substantive plan shall be immediately recognized as a loss or gain."

## **Assumptions**

Obligations will be measured using an explicit approach to assumptions that reflect the employer's best estimate of the plan's future experience with respect to each assumption, taking into account only currently active and retired plan participants. Expected changes in the law (e.g., Medicare) cannot be anticipated in measuring the obligations and expense--this would be accounted for only when a new law is actually enacted.

### **The Health Care Cost Trend**

To project future retiree health costs, the health care cost trend assumption will be applied to current average per capita costs for retirees. Effectively, what an employer is paying today will be projected for anticipated changes in future health care costs. This assumption is unique to postretirement health care benefits and represents expected changes in the costs of the benefits currently provided under the plan due to factors other than the demographic mix of the population.

The health care cost trend assumption (i.e., the estimate of projected change in health care costs) should consider estimates of health care inflation, changes in health care utilization or delivery patterns, technological advances and changes in the health status of plan participants. In selecting the health care cost trend rate, the Standard recognizes that it may be appropriate to use different rates for different services (e.g., hospital care, vision and dental, or physician services).

The Standard also recognizes that health care costs may not increase at a uniform rate over time. Generally, actuaries look to expectations of near-term cost increases and gradually trend down over time to a rate ultimately expected to prevail. The ultimate rate (e.g., 5.50%) may be tied to a level that exceeds the estimate of general inflation (e.g., 3.25%).

### **The Discount Rate**

The discount rate assumption reflects the time value of money. In selecting this assumption, employers should look to rates of return on high quality, fixed-income investments currently available and expected to be available during the period the benefits are expected to be paid.

**Assumptions**  
(cont'd)

**Administrative Expenses**

The Standard specifies that an assumption for administrative expenses--both external costs and direct internal costs, if significant--should be included in the measurement of obligations and expense. These expenses are often expressed as a percentage of health care claims.

**Other Assumptions**

As is done in pension accounting, assumptions concerning employee turnover, retirement age and mortality are used to estimate the amount and timing of future retiree benefit payments. In addition, a dependency status assumption (i.e., an estimate of the number of retirees that will have a spouse or other dependents receiving benefits) is necessary in plans that extend retiree benefits to dependents.

**Definition of  
Plan Assets**

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Under SFAS No. 106, plan assets may be used to offset postretirement benefit obligations for balance sheet purposes. Moreover, expected earnings on plan assets can reduce expense under accrual accounting.

As defined by the Standard, plan assets will need to be segregated from the general assets of the company, restricted as to use (usually in a trust) and maintained exclusively for benefits payable or ex-benefits payable or expected to be paid under the plan.

**Liability  
Recognition**

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Under the Standard, annual expense would be computed first, the accrued liability reported in the balance sheet will then reflect the difference between the cumulative accrued expense and the actual amounts paid (or funded).

**Transition  
Accrual  
Accounting**

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While a single measurement approach is required, SFAS No. 106 allows some flexibility in selecting a transition approach. First, employers have the option of selecting the date of adoption, as long as this date is not later than the required adoption date (i.e., the beginning of fiscal 1993, or fiscal 1995 for nonpublic employers with up to 500 plan participants).

**Transition  
Accrual  
Accounting  
(cont'd)**

Employers then have the choice to immediately recognize the transition obligation at that date, or amortize the obligation to expense over future years. Immediate recognition will be permitted only at the adoption date, and the entire past service obligation at that date must be charged to expense as a cumulative catch-up adjustment.

**Immediate recognition.** The amount of the transition obligation that can be immediately recognized excludes:

- The effects of a plan initiation or benefit improvement adopted after December 21, 1990; and
- The amount that relates to a purchase business combination that was consummated subsequent to December 21, 1990 (see also "Business Combinations").

**Delayed recognition.** For those employers choosing delayed recognition, the transition obligation will be amortized on a straight-line basis over the average remaining service period of active plan participants, unless:

- The average remaining service period is less than 20 years, in which case the employer may elect a 20-year amortization period; or
- Almost all of the plan participants are inactive, in which case the employer would amortize the transition amount over their average remaining life expectancy.

Employers will be required to accelerate the amortization of the transition obligation if aggregate benefit payments to all plan participants exceed the cumulative expense. This is known as the pay-as-you-go constraint.

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**Plan  
Amendments  
and Plan  
Initiation**

Positive plan amendments (amendments that increase retiree health benefits) or a plan initiation is generally considered retroactive and immediately increases the APBO. The increase in APBO relating to retirees and active employees will be amortized to expense over the remaining service periods (to the full eligibility date) of plan participants active at the date of the amendment who are not yet fully eligible for benefits.

**Plan  
Amendments  
and Plan  
Initiation**  
(cont'd)

A reduction in the obligation due to a negative plan amendment (a plan amendment that reduces the retiree health benefit) will first be used to reduce any existing unrecognized prior service cost. Any remaining unrecognized transition obligation would then be reduced. Any excess would be amortized over the remaining service periods (to the full eligibility date), similar to positive amendments.

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**Components  
of Expense**

SFAS No. 106 requires that an employer's postretirement benefit expense include a number of components. In general terms, these components are:

- **Service cost**--The portion of the EPBO attributable to employee service for the period (increases the APBO) calculated using the beginning-of-the-year discount rate and the required attribution method.
- **Interest cost**--The increase in the APBO attributable to the passage of time. It is calculated by applying the beginning-of-the-year discount rate to the beginning-of-the-year APBO, and is adjusted for interest on benefit payments to be made during the period.
- **Expected return on plan assets** -- return on plan assets -- For funded plans, the expected earnings rate applied to the market-related value of the plan's assets, adjusted for contributions and benefit payments to be made during the period. Although the Standard calls for the actual return on plan assets, the difference between the expected and actual return is included in the gain or loss component. Thus, an employer's annual expense reflects the expected return on plan assets.
- **Prior service cost**--The amortization of the cost of retroactive benefits resulting from plan amendments and/or plan initiation that take place after the Standard is adopted.

**Components  
of Expense**  
(cont'd)

- **Gains and losses**--In general, gains and losses are changes in the APBO resulting from changes in assumptions or from experience different from that assumed. For funded plans, this component also includes the difference between the actual and expected return on plan assets. The Standard allows for delayed recognition of gains and losses. The minimum amount of amortization recognized in expense for the period would be based on a "corridor approach" whereby a company could amortize only the portion of accumulated gains and losses that exceeds 10% of the greater of the APBO or the market-related value of plan assets.
  - **Amortization of the transition obligation or asset**--As discussed above, straight-line amortization of the unrecognized APBO at the date the Standard is adopted. This component of expense is not present if the transition obligation is immediately recognized.
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**Accounting for  
Settlements**

As in pension accounting, a settlement is defined as a transaction that:

- is an irrevocable action;
- relieves the employer (or the plan) of primary responsibility for a postretirement obligation; and
- eliminates significant risks related to the obligation and the assets used to effect the settlement.

When a settlement occurs, employers will be required to immediately recognize deferred gains and losses, except that settlement gains would first be offset against the remaining unrecognized transition obligation. There would otherwise be no acceleration of the unrecognized transition obligation or of unrecognized prior service costs.

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**Accounting for  
Curtailments**

A curtailment is defined as an event that significantly reduces the expected years of future service of active plan participants or eliminates the accrual of benefits for some or all of the future service of a significant number of active plan participants. Typical situations include reductions in work force or plan suspensions, or terminations that result in elimination of future benefit accruals for some or all employees.

**Accounting for  
Curtailments**  
(cont'd)

When the occurrence of a curtailment is probable and the extent (dollar effect) can be reasonably estimated, an employer should compute a curtailment gain or loss. Curtailment losses would be recognized in earnings when the occurrence of a curtailment is probable and the net effect is estimable; curtailment gains would be recognized when the related employees terminate or when the plan amendment or suspension is adopted. The Standard provides the computational requirements for determining the net gain or loss from a curtailment; basically, the net gain or loss is the sum of the following two items:

- a loss computed as the portion of unrecognized prior service costs (arising from any remaining unrecognized transition obligation or the cost of retroactive plan amendments) that relates to years of service no longer expected to be rendered; and
- a gain or loss computed as the net change in the APBO resulting from the event; however, this net change must first be offset against any existing unrecognized net gain or loss.

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**Other  
Accounting  
Issues**

SFAS No. 106 provides guidance in the accounting for other aspects of postretirement benefits.

**APB Opinion No. 12 Amendment, Deferred Compensation Contracts**

The Standard amends paragraph six of APB Opinion No. 12, Omnibus Opinion - 1967, to require that amounts to be paid under individual deferred compensation contracts be fully accrued by the date the employee is fully eligible to receive benefits under the contract (i.e., the "full eligibility date"). With respect to contracts that do not provide postretirement health and welfare benefits, this amendment is effective for fiscal years beginning after March 15, 1991 (e.g., the first quarter of 1992 for calendar year companies). Companies will be required to record a cumulative catch-up adjustment for these contracts to be fully accrued as of the full eligibility date.

## **Business Combinations**

After employers adopt SFAS No. 106, paragraphs 86-88 require that the acquiring company establish a liability for postretirement benefits equal to the difference between the APBO--based on the purchaser's assessment of the substantive plan and the necessary actuarial assumptions--and the fair value of plan assets. However, employers are faced with a choice in accounting for acquisitions that take place prior to adopting SFAS No. 106 (e.g., those consummated in 1991).

**Post-December 21, 1990 combinations.** For purchase business combinations occurring after December 21, 1990, but before the Standard is adopted, an employer has the option of recording the postretirement obligation at the date of acquisition in its purchase price allocation. This would generally be consistent with current accounting practice.

When SFAS No. 106 is adopted by those employers who did not reflect the acquired postretirement benefit liability in their purchase accounting, paragraph 111 requires that an employer electing immediate recognition of its transition obligation be precluded from immediately recognizing in the income statement the transition obligation related to the acquired entity. Instead, that amount should be included in the assignment of the purchase price to assets acquired and liabilities assumed, thereby generally causing an increase in recorded goodwill. Accordingly, an employer who elects immediate recognition when adopting this Standard, but has not recorded the obligation assumed, shall retroactively adjust the purchase price allocation (and restate prior years' financial statements) to reflect the obligation.

However, if amortization of the transition obligation is elected, the entire transition obligation must be amortized with no adjustment to the purchase price allocation and no restatement of prior financial statements at the date of adoption of the Standard.

**Other  
Accounting  
Issues**  
(cont'd)

**December 21, 1990 and prior combinations.** The Standard includes no special provisions for business combinations that have been consummated on or prior to December 21, 1990. As such, if the company elects immediate recognition of the transition obligation, the APBO of all previously acquired businesses must also be immediately recognized in the cumulative catch-up adjustment. If delayed recognition is elected, the acquired company's obligation would not be treated differently from that of the acquiring entity.

**Employers With Two or More Plans**

Unfunded plans may be aggregated for measurement purposes if the plans provide different benefits to the same group of employees or if the plans provide the same benefits to different groups of employees.

Funded plans would not be aggregated with unfunded plans for measurement purposes. In terms of disclosure:

- Health care plans could be combined with other welfare plans unless the APBO of the other welfare plans is significant relative to total APBO.
- U.S. plans could be combined with non-U.S. plans unless the APBO of the non-U.S. plans is significant relative to total APBO.
- Overfunded plans may be combined with underfunded plans except that the aggregate APBO and fair value of plan assets of underfunded plans shall be disclosed separately.

**Multiemployer Plans**

A multiemployer plan is defined as a plan to which two or more unrelated employers contribute, usually pursuant to collective bargaining agreements. The expense recognized would be the required contribution to the plan for the period.

**Measurement Date**

Employers would be permitted to select any date up to three months prior to their balance sheet date to perform measurements of their obligations (and related plan assets) for postretirement benefits.

**Other  
Accounting  
Issues  
(cont'd)**

**Special Termination Benefits**

Employers would recognize an expense when employees accept the offer of special termination and the amount can be reasonably estimated.

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**Disclosure**

The disclosures for defined postretirement benefit plans include:

- A description of the substantive plan or plans, including the employee groups covered, types of benefits provided, funding policy and types of assets held;
  - The components of expense;
  - The funded status reconciliation;
  - The assumed discount rate;
  - The assumed health care cost trend rate for the next year. For years thereafter, a general description of the direction and pattern of change with disclosure of the ultimate trend rate and when that trend rate is expected to be achieved; and
  - The effect on the APBO and the service and interest cost components of net periodic postretirement benefit cost of a one percentage point increase in the health care cost trend rate.
-