Accounting for OPEBs: Does Better Accounting Serve the Public Interest?

Dr. Timothy A. Pearson, Accounting, West Virginia University
Dr. Scott I. Jerris, Accounting, West Virginia University
Dr. Richard Brooks, Accounting, West Virginia University

Abstract

In 1992, the Financial Accounting Standards Board (FASB) issued "Employers' Accounting for Postretirement Benefits Other Than Pensions" (SFAS 106). SFAS 106 requires public companies to account for postretirement benefits other than pensions (e.g., health care) on an accrual basis. While SFAS 106 is "good" accounting, it provides corporations with an excellent excuse to amend or terminate health care coverage for retirees. This paper discusses the economic and social consequences of SFAS 106 as well as the politics of the accounting standard setting process.

Introduction

Statement of Financial Accounting Standards No. 106 (SFAS 106), *Employers' Accounting for Postretirement Benefits Other Than Pensions*, became effective for most public companies on December 15, 1992 (FASB 1990). This new standard changed the practice of accounting for postretirement benefits other than pensions (e.g., health insurance) from pay-as-you-go (i.e., cash basis) to accrual. Under SFAS 106, the estimated cost of providing postretirement benefits other than pensions (OPEBs) to current employees and their dependents is charged against current revenues. The Financial Accounting Standards Board (FASB) believes that the accrual of OPEB obligations provides financial statement users with better information necessary to assess the economic impact of employers' compensation decisions.

The accounting requirements of SFAS 106 are similar to SFAS 87, *Employers' Accounting for Pensions*, which became effective for all public companies on December 15, 1988 (FASB 1985). SFAS 87 changed the practice of recording annual pension expense from a pay-as-you-go basis (cash basis) to an accrual basis. The primary reason for issuing SFAS 106 was to make accounting for OPEBs consistent with the accounting for pensions.

There are, however, some fundamental differences between pensions and OPEBs.[1] First, in terms of the cost to the employer, pension costs are usually fixed amounts payable monthly. In contrast, OPEB health care costs can vary greatly and be extremely high. For example, the total cost of treating illnesses such as heart disease, cancer, and AIDS are astronomical. In addition, the elderly experience a number of chronic health problems requiring ongoing care and treatment. Second, the Employee Retirement Income Security Act (ERISA) of 1974 requires funding of vested, defined pensions. OPEBs are not subject to any mandatory funding laws. Third, pension expense is tax deductible whereas OPEB expense is not. Finally, the beneficiary of a pension plan is typically either the employee or his/her spouse. The beneficiaries of OPEBs may include not only the retired employee and his/her spouse but also the retiree's dependents.

Since accrual accounting is the backbone of financial statement reporting, few accountants will argue that SFAS 106 does not improve the decision usefulness of accounting information by incorporating relevant, previously undisclosed, information into the general purpose financial statements. Some accountants might argue, however, that the measurement of certain items on the income statement (OPEB expense) and balance sheet (OPEB asset or liability) is unreliable due to the potentially unlimited dollar amount of future cash outflows. Other accountants, including those on the Financial Accounting Standards Board (FASB), believe that the accrual of OPEB expense based upon estimates is superior to non-accrual. Non-accrual of this liability implies that the employer has no obligation, when a contractual or moral obligation may in fact exist. Hence, not disclosing this liability may be misleading and may impair the decision usefulness of the financial statements.

Statement of Financial Accounting Concepts No. 2 (SFAC 2), *Qualitative Characteristics of Accounting Information*, requires that the benefits of an accounting standard exceed the costs of implementing and maintaining the standard (FASB 1980). The cost of implementing and maintaining a new accounting standard may fall upon one or more groups. The direct cost of implementing and maintaining compliance with a new standard generally falls upon the companies and shareholders affected by a new standard. Therefore, these companies are likely to lobby the FASB during the standard setting process. Regardless of the outcome of the lobbying effort, the manner in which firms react to a new accounting standard sometimes indirectly affects third parties. The FASB does not, however, consider the impact of a new accounting standard on parties indirectly affected by a proposed accounting standard unless the affected group makes its voice heard during the due process procedures. By not recognizing the costs of accounting standards on indirectly affected parties the FASB may underestimate the "true" cost of implementing and maintaining a proposed accounting standard.

The purpose of this paper is to promote discussion regarding the accounting standard setting process and the societal costs of accounting standards. Compliance with the requirements of SFAS 106 may encourage corporate behavior that adversely affects third parties (e.g., retirees). If firms decide to cancel or reduce health benefits for retirees and their dependents, the cost of these services will fall upon taxpayers as retirees become dependent on public health care programs such as Medicare and Medicaid.

The remainder of this paper is presented in four sections. The first section describes the direct and indirect economic consequences[2] of SFAS 106. The second section discusses the politics of the accounting standard setting process. The third section provides some concluding comments while the final section suggests future research directions.

The Economic Consequences of SFAS 106

Accounting for OPEBs in accordance with SFAS 106 is already having negative consequences for many retirees. According to a study by William Mercer Inc., more than 50% of the 216 private sector health plans included in their study have reduced or restricted benefits for retirees. The Mercer study found that 50% of the plan revisions require a larger contribution from retirees, 34% increase the age and service requirements necessary for eligibility, 26% set caps on the amount of company contributions, and 22% eliminated coverage for future retirees.[3] Because employers must now recognize the cost of OPEB benefits in the body of the financial statements, many employers are reconsidering the postretirement benefit package offered to current and future retirees.

The economic and social impact of SFAS 106 on the corporate bottom line is staggering. Here are some examples: (1) Accounting for retiree health costs in accordance with SFAS 106 will result in a one time charge between $1.2 billion and $1.5 billion for the McDonnell Douglas Corp. In addition, McDonnell Douglas Corp., will phase out health benefits for salaried retirees after four years; (2) Unisys Corp. expects to save $100 million per year by phasing out health insurance for retirees altogether; (3) Chrysler took a $4.7 billion charge in the first quarter of 1993 related to SFAS 106; (4) General Motors took a $20.8 billion charge to income in 1992 related to SFAS 106; (5) The requirements of SFAS 106 forced Ford to take a $7.5 million charge against earnings; (6) Du Pont Co. will take a $5.28 billion charge against earnings in 1992 due to the requirements of SFAS 106. Because of this charge, Du Pont plans to reduce its contributions to health care plans for both active and retired workers. Currently, Du Pont pays 89% of health care costs for employees but will reduce this to 80% on January 1, 1994. If costs continue to increase, Du Pont will reduce their share of health care costs to 50% by January 1, 1997; and (7) IBM took a one-time charge of $2.3 billion against the 1991 first quarter earnings to comply with SFAS 106. Furthermore, IBM is making retirees pay a larger share of their benefit costs.

Under SFAS 106 firms have the option of charging off the entire accrual of OPEBs or amortizing the cost over twenty years. Therefore, firms can minimize the negative effects of this cost by choosing the alternative treatment that best suits their financial condition. Table 1 provides a summary of the possible actions firms can take in response to SFAS 106.

Firms provide OPEBs to their employees on a voluntary basis. Therefore, firms can unilaterally amend or cancel OPEB benefits. The elimination or reduction of OPEBs for retirees shifts the burden of health care coverage for retirees to federal and state programs such as Medicare and Medicaid (M&M). The additional burden on the M&M programs may be significant and may confound attempts to reform the health care system.

The ability of a company to unilaterally cancel or amend OPEBs is primarily a function of contract law. If a company does not have a binding commitment that requires the provision of OPEBs, the company can unilaterally discontinue the plan. However, the law is not clear regarding what constitutes a binding commitment to provide OPEBs. Class action suits are the only recourse for retirees facing the revision or cancellation of OPEBs.

Table 1
Potential Firm Reactions to SFAS 106

	Drop Plan	Modify Plan	Maintain Plan
Charge Full Cost to Earnings in Year of Adoption (i.e., Big Bath)	Socially irresponsible; Minimizes impact on future earnings.	More palatable than dropping plan entirely; Minimizes impact on future earnings.	Socially responsive; Minimizes impact on future earnings.
Amortize Cost Over 20 Year Period	Socially irresponsible; Minimizes impact on future earnings.	More palatable than dropping plan entirely; Spreads the effect of SFAS 106 over future earnings.	Socially responsive; Spreads the effect of SFAS 106 over future earnings.

Studies that investigate the economic consequences of accounting standards typically examine the stock market reaction to the newly disclosed information. This approach only identifies first order effects of accounting standards (i.e., the impact of the information on the market value of the company). These studies do not attempt to consider the second order or indirect effects of these accounting rules. Only by considering the potential actions corporations may take in response to new reporting requirements can we fully understand the consequences of a new accounting standard. Accounting researchers are in a position to (1) develop and test theories regarding the probable actions of management and owners to new accounting standards, and (2) identify parties affected by managements' actions. Finally, accounting academicians can attempt to estimate the social cost of actions taken by corporate management in response to new accounting standards.

The Politics of Accounting Standards

SFAS 106 is not the only accounting standard having public policy implications.[4] Oil and gas accounting, investment tax credit accounting and market value accounting are three examples where public-policy considerations forced accounting standard setters to amend their original decision. In each of these cases FASB took a balance sheet approach that increased the volatility of reported earnings. Powerful business interests convinced policy makers that the proposed or promulgated accounting rules were not in the best interest of corporations or politicians. The discussion below presents several of the more well known cases where public policy and lobbying pressures forced changes in generally accepted accounting principles.

Investment Tax Credit.

In 1962, the Accounting Principles Board issued Opinion No. 2, *Accounting for the "Investment Credit"* (APB 1962). This opinion required the amortization of investment tax credits over the productive life of the acquired asset rather than taken in full in the year of purchase. Due to pressure placed on the Securities and Exchange Commission (SEC) by corporate entities desiring to take the full effect of the income tax credit in the year of purchase, the SEC issued Accounting Series Release No. 96 (SEC 1963). Accounting Series Release No. 96 (ASR 96) allowed corporations to choose the accounting method of their choice, the deferred method (i.e., APB 2 method) or the "flow-through" method (i.e., ASR 96 method). Although the APB argued that the deferred method was "theoretically correct" they bowed to the pressures of the SEC and subsequently issued APB 4, *Accounting for the Investment Credit* (APB 1964). APB 4 amended APB 2 by allowing a choice between the deferred and flow-through methods of accounting for the investment tax credit.

Oil & Gas Accounting.

In 1977, the FASB issued SFAS 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* (FASB 1977). SFAS 19 mandated the amortization of the costs associated with the drilling of productive oil or gas wells over the productive life of the well (successful efforts method); costs associated with drilling a non productive well (i.e., dry hole) are expensed in the period in which the drilling took place. Pressure from corporate entities preferring to amortize the cost of a "dry hole" over the life of productive wells influenced the SEC to issue ASR 253 "*Adoption of Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities.*" ASR 253 (SEC 1978) allows companies to amortize the cost of a dry hole over the life of productive wells (i.e., full-cost method). Following the lead of the SEC, the FASB issued SFAS 25, "*Suspension of Certain Accounting Requirement for Oil and Gas Producing Companies,*" in 1979 that permitted firms to use the full-cost method (FASB 25).

In the basis for conclusions for SFAS 19, the FASB states that: *an asset is an economic resource that is expected to provide future benefits, and nonmonetary assets generally are accounted for at the cost to acquire or construct them. Costs that do not relate directly to specific assets having identifiable future benefits normally are not capitalized--no matter how vital those costs may be to the ongoing operations of the enterprise. If costs do not give rise to an asset with identifiable future benefits, they are charged to expense or recognized as a loss.* While the full-costing approach is inconsistent with the theory espoused above, the FASB issued SFAS 25 that allowed the full-cost approach because of outside pressures.

Market Value Accounting

In the early 1970s the APB wanted to issue an Opinion that allowed the recognition of portfolio gains and losses from the holding of marketable equity securities. However, the SEC strenuously opposed any write-up of asset values. A major reason for this opposition was the reliance placed on historical costs to value assets. The lobbying efforts of the insurance industry to hold down asset values provided another reason for the SEC to oppose market value accounting. According to Hendriksen and Van Breda (1992), pressure from the SEC caused the APB to reconsider issuing an Opinion allowing the recognition of gains when market values exceeded historical costs. In 1993, the FASB issued SFAS 115, "*Accounting for Certain Investments in Debt and Equity Securities*," which allows the use of market values for marketable equity securities (FASB 1993). It is interesting to note that the SEC, who once strenuously opposed market value accounting is now a proponent of market value accounting (Worthy 1992).

Accounting for Employee Stock Option Plans

In 1993 the FASB issued an exposure draft entitled, "*Accounting for Stock-Based Compensation*," that would require companies to recognize and expense, all stock-based compensation awards, including stock options, granted after December 31, 1996 (FASB 1993). According to the exposure draft, the fair market value of the stock compensation award on the date granted is amortized over the vesting period. Currently, there is legislation in the Congress designed to block this new accounting charge against earnings. Specifically, S 1175, "*The Equity Expansion Act of 1993*," introduced by Senator Joseph Lieberman (D-Conn.) would, if enacted, overrule any decision to implement the FASBs exposure draft. A recent issue of the *Journal of Accountancy* quoted Senator Lieberman as saying: *As a matter of abstract accounting theory, FASB's approach to stock option accounting may be defensible, but from a public-policy, job-creation and competitiveness perspective, it simply is unnecessary and unusually disruptive.*[5] The same issue of the *Journal of Accountancy* quotes Dennis R. Beresford, Chairman of the FASB as saying:. . . *neutral financial reporting is critical to the functioning of our economic system and that the best way to achieve that end is to allow the existing private sector process to proceed. Stated simply, truth in accounting is always good policy.*[6] Clearly, Senator Lieberman and Chairman Beresford have different opinions regarding the role of accounting standards in our economy.

Accounting Theory or Public Policy?

Neutrality in accounting standards is a noble goal and is a stated component of FASB's conceptual framework. However, if accounting standards are to be truly neutral we must abandon the current due process procedure that is inherently political and resort to accounting standards that are theoretically sound without regard for their economic consequences. While the FASB attempts to promulgate standards that are theoretically sound, they do compromise theory when a powerful constituent group lobbies against a particular standard. This is a result of the political nature of the accounting standard setting process. Therefore, it is important for groups affected by accounting standards to organize and lobby for the accounting treatment that they prefer. When groups affected by accounting standards do not initiate an organized effort to persuade accounting standard setters to consider their plight, they risk falling victim to standards that may be theoretically justifiable but have severe consequences. Accounting academicians can provide an important service to society by acting as de facto representatives for those groups affected by accounting standards. Accounting academicians can make accounting standard setters as well as potentially affected groups aware of the economic consequences of proposed accounting standards.

To date, powerful interest groups have been successful in mitigating the impact of accounting standards. For example, smaller oil and gas firms argued that the successful efforts method of accounting reduced their reported earnings and thereby made it more difficult for them to acquire capital. In response, the FASB issued SFAS 25 that allows companies to use the full-cost method.

In the case of SFAS 106, academics can explain to Congress and the SEC the potential negative consequences of forcing firms to recognize the cost of postretirement health care costs (e.g., cancellation of health care coverage for retirees, increasing dependence by retirees on public health care programs such as Medicare and Medicaid)

Until retirees lobby for an alternative accounting treatment they must bear the negative consequences of SFAS 106 (e.g., cancellation or modification of OPEBs) and can only hope that the courts will force their former employers to restore their OPEBs.

The FASB's efforts to generate ever more specific standards exacerbate the reaction of effected parties to lobby for alternative accounting treatments. Alternative accounting treatments often allow firms to mitigate the impact of accounting standards on their short-run financial condition. In the past, the FASB has phased in new standards to placate concerns over income volatility due to the reporting requirements of a new accounting standard. However, the FASB does not seem concerned about the substantive economic decisions companies systematically make to avoid the negative effects of new standards. The impact of accounting standards on individuals is of particular concern. Accounting standard setters already consider the economic impact of accounting standards on corporations because corporations lobby the FASB during the due process procedures or lobby the SEC. To be fair, accounting standard setters should also consider the potential impact of accounting standards on groups affected by corporate reaction to those standards. Accounting academicians can assist the FASB in identifying those individuals or groups that may be affected by a proposed accounting standard and the potential effect of the proposed standard. Additionally, accounting academicians can make potentially affected groups aware of the likely impact of a proposed accounting standard so that the affected group can lobby FASB in a manner similar to large corporations.

Concluding Comments

The Securities and Exchange Commission (SEC), which has the legal authority to promulgate generally accepted accounting principles, has in the past and may in the future overrule the FASB in the interest of public policy. SFAS 106 provides corporations with an excuse to cancel health coverage for retirees. The cancellation of retiree health benefits may be perceived as a costly business decision to government policy makers which may cause the SEC to overrule the FASB once again. If the FASB wants to avoid being overruled by the SEC in the future it must consider *all* the potential costs of issuing or modifying an accounting standard.

Suggestions for Future Research

The decision to maintain, modify or cancel OPEB plans may be a function of management's incentives and current financial conditions. Future researchers should investigate the relationship between the accounting treatment of OPEB expenses and (1) management's incentives, and (2) the current financial condition of a firm. For example, the cancellation of OPEBs may be more likely if a large portion of management's compensation is dependent on short-term profits. Similarly, the cancellation of OPEBs may be more likely if a company is in poor financial condition. Finally, companies expecting poor results for the year in which SFAS 106 is adopted may choose to maintain their OPEB plans and expense the entire amount in one lump sum (i.e., take a "big bath" during an already poor fiscal period) to mask poor results from operations.

❁❁❁ Notes ❁❁❁

1. This discussion assumes that the most costly component of OPEBs is health care.
2. The term "economic consequences" concerns the impact of accounting standards on the behavior of affected parties (Zeff 1994).
3. "News Report," *Journal of Accountancy*, October 1993, p. 22.
4. See Solomon's (1978) for a spirited discussion regarding the use of accounting standards to attain public policy objectives.
5. "News Report," *Journal of Accountancy*, October 1993, p. 15.
6. "Highlights," *Journal of Accountancy*, October 1993, p. 4.

❁❁❁ References ❁❁❁

1. Accounting Principles Board. *Opinion No. 2, Accounting for the "Investment Credit,"* New York, NY: AICPA, 1962.
2. Accounting Principles Board. *Opinion No. 4, Accounting for the "Investment Credit,"* New York, NY: AICPA, 1964.
3. Financial Accounting Standards Board. *Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information*, Stamford, CT: FASB, 1980.
4. Financial Accounting Standards Board. *Statement of Financial Accounting Standards No. 19, Financial Accounting and Reporting by Oil and Gas Producing Companies*, Stamford, CT: FASB, 1977.
5. Financial Accounting Standards Board. *Statement of Financial Accounting Standards No. 25, Suspension of Certain Accounting Requirement for Oil and Gas Producing Companies_*, Stamford, CT: FASB, 1979.
6. Financial Accounting Standards Board. *Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions*, Stamford, CT: FASB, 1985.
7. Financial Accounting Standards Board. *Statement of Financial Accounting Standards No. 106, Employers'*

Accounting for Postretirement Benefits Other Than Pensions, Norwalk, CT: FASB, 1990.

8. Financial Accounting Standards Board. *Statement of Financial Accounting Standards No. 115, Accounting for Certain Investment in Debt and Equity Securities*, Norwalk, CT: FASB, 1993.
9. Financial Accounting Standards Board. *Exposure Draft, Proposed Statement of the Financial Accounting Standards Board, Accounting for Stock Based Compensation*, Norwalk, CT: FASB, 1993.
10. Hendriksen, E. and M. Van Breda. *Accounting Theory*, (5th edition), Boston, MA: Irwin, 1992, p. 239.
11. "Highlights." *Journal of Accountancy*, October 1993, p. 4.
12. "News Report." *Journal of Accountancy*, October 1993, pp. 15, 22.
13. Securities and Exchange Commission. *Accounting Series Release No. 96*, Washington, DC: SEC, 1963.
14. Securities and Exchange Commission. *Accounting Series Release No. 253, Adoption of Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities*, Washington, DC: SEC, 1978.
15. Solomons, D. "The Politicization of Accounting," *Journal of Accountancy*, November 1978, pp. 65-72.
16. Worthy, F. "The Battle of the Bean Counters," *Fortune*, June 1, 1992.
17. Zeff, S. "The Rise of Economic Consequences," in *Readings and Notes on Financial Accounting_Issues and Controversies*, (Zeff, S. and B. Dharan, Eds.), New York, NY: McGraw-Hill, Inc. 1994.