Corporate Financial Statements and The Impact of Health Care Costs Recognition

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ABSTRACT

This paper empirically analyzes the economic consequences of a forthcoming rule on accounting for post-retirement obligations. This rule calls for the recognition of health care liabilities on the employers' financial statements and prescribes that the cost associated with these obligations be accounted for on the accrual basis. Based on a sample of 103 firms, this study reports that compliance with this rule could have a dramatic impact on firms' equity, leverage, income and key financial ratios.

INTRODUCTION

Important changes occurring within the health care industry are causing dramatic consequences in corporate America. Schmidt (1989) reports that in the past twenty years, the overall cost of health care has skyrocketed from $42 billion to $500 billion and currently health care cost represent about 11% of the GNP. This trend appears to be one that will continue well into the future and a recent survey by Foster Higgins (1988) report that per employee health costs have increased by 19% from 1987 to 1988. With the increasing uncertainty around future health care obligations, the Financial Accounting Standards Board (FASB) has responded by making some radical changes in accounting for retiree health care costs.

In early 1989 the FASB issued a proposed statement of financial accounting standards which is likely to have the greatest impact of any accounting standard issued to date. The release of the above statement has not been favorably received in the popular financial press and has produced titles such as, "First Thing We Do Is Kill All The Accountants" (1). The proposed standard relates to accounting for post-retirement benefits other than pensions (OPEB), such as health care, life insurance, and tuition reimbursement. Previously, these benefits have been expensed on employer's books as incurred, with no liability recognized for anticipated future payments. The new standard prescribes that the cost associated with these post-retirement benefits be accounted for on the accrual basis. Also, the standard calls for the recognition of future health care liabilities on the balance sheet itself in a manner similar to the treatment of pension liabilities. The General Accounting Office estimated that as of 1988, the total potential retiree health benefit liabilities for current workers and retirees are about $402 billion (2). Many firms have not started funding for these obligations and it is estimated that the total annual contributions to trust funds could be as much as $34 billion, an amount equal to one-eighth of the pre-tax profits of American corporations (3).

Previously, it was widely believed that the retiree health care liabilities are no legal obligations and the liabilities were avoidable. All that has changed and the FASB has concluded that it is an obligation at least implicitly and should be recognized in the employer's financial statements (4). The economic consequences of this rule is anticipated to be very dramatic. An article in the *Business Week* (1988) reports that this rule could knock out at least 25% off the annual profits of big industrial firms and wipe out one-third of the net worth of all corporate America. For some firms, this could be their largest liability. Several firms are likely to experience substantial increase in their debt to equity ratios and even face technical defaults as a result of debt covenant violations (5). In addition, impact on reported earnings as a result of expensing accrued health care cost for many firms are likely to be severe. The switch to accrual accounting from pay-as-you-go approach is likely to run 8 to 12 times for new companies with

younger work force and few retirees. On top of this, firms have less incentives to prefund these liabilities: currently, contributions to the health care fund are not tax deductible.

This paper assesses the impact of the proposed OPEB standard on corporate financial statements. A number of articles have appeared in the popular press about the likely economic consequences of this accounting rule. However, only a very few studies have empirically analyzed the impact of the retiree liability recognition on the balance sheet and income statement of the various employers. For example, the results of a field test of OPEB project jointly conducted by the Financial Executives Research Foundation (1989) and Coopers & Lybrand show for a sample of twenty six firms that the recognition of the liability could significantly reduce stockholders' equity and increase debt to equity ratio of a firm. However, the generalizability of the field test results are limited for the following two reasons. First, it is based on a small sample and second, due to the confidentiality of the field test, the actual names of the firms participating and the industry category they belong to are not available.

DATA

The present analysis is based on a sample of 103 firms which is large enough to assess the degree of impact of post-retirement liability recognition and switch to accrual accounting on equity, leverage and net income of a firm. The data for this study came from a variety of sources. The information on the accumulated post-retirement benefit obligation (APRBO) and the impact on net income were obtained from an article published in *Barron's* by Diana Henriques (1989). The pension related information such as projected benefit obligations and pension assets available for the sample firms were obtained from the 1987 annual reports. Information on the effective tax rates, long-term debt, market value of equity, SIC codes, number of employees and earnings per share were obtained from the COMPUSTAT database. All data is for the year 1987.

IMPACT OF POST-RETIREMENT OBLIGATION ON EQUITY

Tables 1 and 2 shed light on the magnitude of the impact of the post-retirement liabilities on the balance sheet. The ten firms with the greatest post-retirement obligations are ranked in Table 1. Heading the list is General Motors with $ 5.33 billion of potential retiree health care liability. *Accounting Today* (1989, p.34) reports that the average cost of providing health care coverage to General Motor's employees works out to about $600 per car. The post-retirement obligation accounts for about 28% of General Motor's 1987 equity. In terms of accumulated post-retirement obligations (APRBO) as a percentage of equity, (Table 2) the company that is most severely affected was McDonnel Douglas. The mean amount of post-retirement obligations for the 103 firms in our sample was $504 million which was about 9% of the total equity of the sample.

IMPACT ON LEVERAGE

Results presented in Table 3 highlights the degree of impact on leverage for the sample firms. Table 3 ranks the top ten corporations in terms of increase in debt to equity ratio for 1987 as a result of recognizing APRBO. The variable INCDEBT is the incremental debt to equity ratio. INCDEBT is calculated by subtracting the firm's debt to equity ratio (D/E) from an adjusted debt to equity ratio where the APRBO is added to the numerator as incremental debt. The INCREASE represents the percentage change in the firm's debt to equity ratio ((INCDEBT)/(D/E) X 100).

Table 3 shows that for some firms the rate of increase in debt to equity ratio can be dramatic as in the case of Navistar International (385%), McDonnel Douglas (155%) and Lockheed Corporation (103%). Overall, for the sample firms the debt to equity ratio would increase by 0.18 or 58%.

Currently, contributions to health care trust funds are not tax deductible unlike contributions to pension funds which are tax deductible. In seeking tax relief from Congress, firms have requested that the government permit either the transfer of excess pension fund assets to help fund employee health benefits or the tax deductibility of contributions made to pay for such benefits. Scheibla (1988) reports that in 1988, industry trade associations lobbied Congress to eliminate the ten per cent excise tax presently associated with the transfer of pension funds. As yet, Congress has not acted on either proposal. Some sources have indicated that Congress is unlikely to provide much assistance to firms on this matter. With present demands to control the federal deficit, a tax deduction for the contributions to health care benefits is very unlikely. Recently, Senator Bob Packwood (R-Ore.) and Rod Chandler (R-Wash.) have introduced legislation that would make several changes in the tax code to increase access to affordable long-term care and retiree health benefits for seniors. Specifically, the bill would permit employers to pre-fund annual retirement benefit of $1,500 for retiree health care and $1,500 for long term care for their employees

TABLE 1

TOP TEN CORPORATIONS IN TERMS OF ACCUMULATED POSTRETIREMENT BENEFIT OBLIGATIONS FOR 1987

	Company	APRBO (MM $)	APRBO/EQTY (%)
1.	General Motors	$5,330	28
2.	Ford Motor	4,223	23
3.	General Electric	2,417	6
4.	AT & T	2,177	8
5.	IBM	1,717	3
6.	Chrysler	1,296	26
7.	Dupont	1,157	6
8.	Rockwell Intl	1,035	15
9.	Exxon	986	2
10.	Boeing	976	17
	Mean for 103 firms	504	9

TABLE 2

TOP TEN CORPORATIONS IN TERMS OF ACCUMULATED POSTRETIREMENT OBLIGATIONS AS % OF EQUITY

	Company	APRBO/EQTY (%)	APRBO (MM $)
1.	McDonnel Douglas	39	$892
2.	Navistar Intl	36	431
3.	General Motors	28	5,330
4.	General Dynamics	27	560
5.	Lockheed	27	589
6.	Chrysler	26	1,296
7.	Northrop	25	299
8.	Ford Motor	23	4,223
9.	Goodyear Tire	20	687
10.	AMR	20	408

TABLE 3

TOP TEN CORPORATIONS IN TERMS OF INCREASE IN DEBT TO EQUITY RATIO FOR 1987 AS A RESULT OF ACCUMULATED POSTRETIREMENT LIABILITY RECOGNITION

	Company	INCDEBT	INCREASE (%)
1.	Merrill Lynch	1.70	10
2.	McDonnel Douglas	1.07	155
3.	General Motors	0.82	74
4.	Navistar Intl	0.66	385
5.	Chrysler	0.63	85
6.	AMR	0.60	42
7.	Lockheed	0.59	103
8.	Westing House	0.59	42
9.	Northrop	0.58	78
10.	Goodyear Tire	0.52	49
	Mean for 103 firms	0.18	58

(6). The above bill also would permit employers to use excess pension plan assets in excess of 150% of current pension liabilities to pay for retiree health costs.

IMPACT ON EARNINGS

Tables 4 and 5 list the ten firms that are most seriously affected as a result of switch to accrual accounting from pay-as-you-go accounting.

The percentage of decline in net income can be dramatic for some firms such as General Signal (130% down), Polaroid (72%) and Combustion Engineering (68%). In terms of decline in absolute dollars the firms that are most severely affected are General Motors ($968 million), Ford Motor ($718 million), General Electric ($455 million). Overall, for the sample firms the mean decrease in net income was $97 million or 18%. The decline in net income could have dramatic impact on the earnings per share (EPS). The percentage decline in EPS for Dresser Industries was a whopping 90%. Overall, the mean percentage decline in EPS for the 103 firms was 24%.

TABLE 4

TOP TEN CORPORATIONS MOST SERIOUSLY AFFECTED IN 1987 AS A RESULT OF SWITCH TO ACCRUAL ACCOUNTING

Company Name	Decrease in Net Income ($ M)	Percentage change in NI
1. General Motors	$968	-22
2. Ford Motor	718	-13
3. General Electric	455	-13
4. AT & T	424	-19
5. IBM	401	-7
6. Chrysler	227	-22
7. Dupont	201	-9
8. Boeing	193	-31
9. Rockwell International	189	-24
10. Exxon	176	-3
Mean for 103 firms	97	-18

TABLE 5

TOP TEN CORPORATIONS MOST SERIOUSLY AFFECTED IN 1987 AS A RESULT OF SWITCH TO ACCRUAL ACCOUNTING

Company Name	Percentage change in Net Income	Percentage change in EPS
1. General Signal	-130	-32
2. Polaroid	-72	-14
3. Combustion Engineering	-68	-71
4. Northrop	-59	-65
5. McDonnel Douglas	-48	-54
6. Pennzoil	-34	-20
7. Goodyear Tire	-34	-15
8. Dresser Ind.	-33	-90
9. Northern Telecom	-32	-16
10. General Dynamics	-32	-28
Mean for 103 firms	-18	-24

IMPACT ON STOCK PRICES

It is not very clear at this point whether the impact on stock prices is going to be unfavorable or minimal. The response from the analyst community and management is rather mixed. An article in *Accounting Today* (1989) reported the results of a survey of health care analysts working for major equity fund managers on the impact of liability recognition on stock prices. Three-quarters of the analysts surveyed indicated that stock prices of firms with large number of retirees would suffer because of the rule. A similar view was shared by Harold Dankner, Coopers & Lybrand partner in charge of the research team that conducted a field test of the OPEB exposure draft (7). On the other hand, Lee Seidler (1989, p.8) of Bear Stearns posit that the proposal will not, ultimately, be as dire as some now predict. Seidler believes that by the time OPEB is implemented (which will be mid-1990s), reactions by companies, legislative relief in the form of tax deduction and compromises by the FASB will have diluted its impact. Some people believe that the stock prices does not fully reflect the potential health care liabilities because few firms know how big the price tag is going to be. For example, Diana J. Scott, OPEB project manager at FASB said, "We were absolutely appalled" (8). Apparently many firms did not even know whom they were covering as dependents and employers might have promised much more than what they can ever give. Similarly, Robert Willens, a senior vice president at Shearson Lehman Hutton noted, "They (health care obligations) are not even close to being reflected in the stock prices." (9).

SUMMARY

The Financial Accounting Standard Board's proposed accounting for retirees health care obligations will have a significant impact on employers financial statements, particularly on the balance sheet if implemented in its present form. For a sample of 103 firms, the average post-retirement obligation in 1987 was $504 million and accounted for about 9% of equity. The recognition of this new liability could increase firms' debt to equity ratio by 0.18 or 58%. From the income statement point of view, the switch from pay-as-you-go basis to accrual accounting means a decrease in net income of about $97 million or 18% for the 103 firms examined. On an average this would decrease earnings per share by about 24%.

This article identified and examined several economic consequences associated with the OPEB project. The analyses presented in this article have important implications for commercial lenders, management, auditors and business academics. This article is the first step in understanding the impact of the retiree health care liabilities on corporate financial statements. As a final note, we caution the readers that the above analyses are very preliminary. Currently, accurate estimates of the accumulated post-retirement obligations are not available and very few firms disclose them as part of the footnotes to the financial statements. We realize that our analyses are not conclusive but it may be the only empirical evidence gathered to date on the impact of retiree liabilities recognition on corporate financial statements.

FOOTNOTES

1. See *Business Week*, "First Thing We Do Is Kill All The Accountants", September 12, 1988, p.94.
2. United States General Accounting Office Testimony: Future Security of Retirees Health Benefits in Question, September 15, 1988.
3. LTV Corporation and Ameritech are some of the few firms that have already started pre-funding these liabilities. *Wall Street Journal* (September 5, 1989) reported that LTV Corp recorded a $2.26 billion charge in 1988 to reflect the potential cost of medical benefits for its 118,000 current and retired employees. *Pensions and Investment Age* (February 20, 1989) stated that Ameritech made an initial contribution of $50 million under a new long-term program to fully prefund on an accrual basis its retiree health care benefits.
4. The FASB has concluded that post-retirement benefit is a type of deferred compensation (*Exposure Draft on Employers' Accounting for Post-retirement Benefits Other Than Pensions*, 1989, para.125). The FASB has also concluded that this obligation meets the characteristics of a liability as defined by the Concepts Statement No. 6, *Elements of Financial Statements* (Exposure Draft, para.133-138).
5. Interestingly, Standard & Poor's Corporation (S&P) issued a statement (*Wall Street Journal*, September 5, 1989) that if the FASB adopts the controversial health care accounting rule, it will ignore it. S&P indicated that the FASB's approach is flawed due to the highly speculative assumptions underlying the numbers involved. Also, S&P said that it will focus on current cash outlays rather than accrual based expense required under the FASB's approach. It remains to be seen what the other credit rating agencies are going to do about the disclosures required under the OPEB project.
6. See *Deloitte & Touche Review*, "Washington Briefing", March 12, 1990.
7. See *Financial Executives Institute News*, "Proposed Retiree Health Benefits Accounting Will Impact Company Earnings", 1989.
8. See *Business Week*, September 12, 1988.
9. See *Barron's* April 17, 1989.

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