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Report to the Ranking Minority Member, Committee on the Budget, House of Representatives

May 1992

FINANCIAL REPORTING

Accounting for the Postal Service's Postretirement Health Care Costs

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

B-247454

May 20, 1992

The Honorable Willis D. Gradison, Jr.
Ranking Minority Member
Committee on the Budget
House of Representatives

Dear Mr. Gradison:

In response to a request by your predecessor, former Representative William Frenzel, we analyzed the U.S. Postal Service's accounting and budgetary treatment of certain employee benefit costs. Our previously issued report entitled, Budget Issues: Budgetary Treatment of Postal Workers' Compensation Costs (GAO/AFMD-91-50, April 26, 1991), addressed one component of the request. This letter examines the manner in which the Postal Service reports employer's postretirement health care costs in its financial statements. It also discusses the impact that alternative approaches for funding these costs may have on future postal rates.

Results in Brief

The Postal Service's pay-as-you-go accounting for postretirement health benefit costs is in accordance with private sector generally accepted accounting principles (GAAP). However, disclosure of the full amount of accrued benefits earned by Service employees and retirees in notes accompanying the financial statements would provide the Congress, the executive branch, the Postal Rate Commission, and the public with more complete information to deal with oversight matters, assess rate change requests, and evaluate performance. Accordingly, we disagree with the Postal Service's view that it would be impractical and confusing to disclose these future costs in notes to the financial statements.

Regardless of how health care costs are accounted for and funded, estimates provided by the Postal Service showed that the Service will probably require at least a 1-cent rate increase in current dollars for First Class Mail by the year 2003. If they are accrued and fully funded, first class rates could jump by 3 cents as early as 1994,[1] increase again by only a cent by 2011, and then decrease thereafter. Conversely, on a pay-as-you-go

[1]Although rate increases are usually allocated among the various classes of mail, only First Class Mail is shown here for illustration purposes.

basis, smaller, but more frequent rate hikes would be necessary, an average of about 1 cent every other year after 2011.

Background

The Postal Reorganization Act, enacted in 1970 (Public Law 91-375), created the U.S. Postal Service, which replaced the Post Office Department and began operations July 1, 1971. The Postal Service was to operate as an independent, business-type entity. As such, the Service was to (1) provide quality service and achieve financial self-sufficiency (that is, break even) over a period of years, (2) set rates based on Postal Rate Commission recommendations, (3) retain and use postal revenues, and (4) borrow for operating and investment capital.

The Postal Service follows GAAP, which are issued by the Financial Accounting Standards Board (FASB) and are applicable to private sector entities when preparing annual financial statements. Auditors of the Service use GAAP as the criteria when rendering an opinion on the fair presentation of its statements.

Federal Employees Health Benefits Plan

Postal Service employees, as well as other federal employees, are eligible to participate in the Federal Employees Health Benefit Plan (FEHBP), which was established by the Federal Employees Health Benefits Act of 1959. All federal retirees who have participated in FEHBP for at least 5 consecutive years immediately preceding retirement on a federal pension are eligible to participate.

FEHBP is administered by the U.S. Office of Personnel Management (OPM) and operates on a pay-as-you-go basis. This means that OPM needs sufficient funds to meet the premium costs of current retirees' benefits. OPM gets these funds from three sources. It deducts federal retirees' share of the premium from their retirement annuities and, for all retirees except Postal Service retirees, receives an annual appropriation for the government's share of the costs. The Postal Service is responsible for the government's share of the costs for Service retirees.

The Omnibus Budget Reconciliation Act (OBRA) of 1990 requires the Postal Service to pay \$0.3 billion for fiscal year 1991 and a projected \$0.4 billion and \$0.5 billion for fiscal years 1992 and 1993, respectively, into FEHBP for its current share of postretirement health care benefit premiums. In addition, the OBRAs of 1985, 1987, and 1990 made the Postal Service liable for an additional \$1.2 billion to cover the employer's share of FEHBP premiums for the employees (and their survivors) who have retired since June 30, 1971.[2] The Postal Service is to pay the $1.2 billion into FEHBP over a 9-year period beginning in 1987.

Accounting for Postretirement Health Care Benefits

Since the Consolidated Omnibus Budget Reconciliation Act of 1985 first required the Postal Service to pay the Government's share of postretirement health care costs, the Service has accounted for these costs on the pay-as-you-go basis. However, as a result of FASB Statement 106, Employer's Accounting for Postretirement Benefits Other Than Pensions, issued in 1990, the required accounting treatment for fiscal year 1994 and thereafter will depend upon the type of plan in which the Postal Service determines that it is participating. The new standard identifies two basic types of plans: (1) the multiemployer plan, which requires the pay-as-you-go basis of accounting, and (2) the multiple-employer or single-employer plan, which requires the accrual basis of accounting.

A multiemployer postretirement benefit plan is generally defined as a plan to which two or more unrelated employers contribute and the participating employer does not exercise complete or significant control over (1) the selection of insurance carriers, (2) the selection of benefits available to its employees and retirees (which determine the carriers' risks and rates), (3) the resulting costs it incurs, and (4) the assets it has contributed to the plan. This type of plan requires the pay-as-you-go basis, under which employers recognize expenses when payments are required for current retirees. The plan assumes that costs are measured by the periodic amounts required by, or billed to the employer by, the plan. This method is similar to the cash basis of accounting in that the plan is required to pay health insurance carriers all amounts billed, or due, for the current period on behalf of current retirees. Only amounts billed and/or due, but unpaid at year-end, would be recorded as an accrued expense and recognized as a liability.

Single-employer or multiple-employer plans allow the sponsoring employer control over (1) the selection of insurance carriers, (2) the selection of

[2]From 1959 until October 1, 1986, the government's share of Postal Service retirees' health care costs was paid through an annual appropriation. The Consolidated Budget Reconciliation Act of 1985 required the Postal Service to pay these costs for employees who retired after October 1, 1986. The Omnibus Budget Reconciliation Act of 1990 requires the Postal Service to pay these costs retroactively to cover employees who had retired since June 30, 1971, the effective date of the Postal Reorganization Act.

benefits available to its employees and retirees, (3) the resulting costs it incurs, and (4) the assets it contributes to the plan.

Under the accrual basis, which is required for the single-employer or multiple-employer plans, employers recognize costs in the period their employees earn the benefit. Unlike the pay-as-you-go basis, where expenses are determined simply by the amount of cash due related to the period, the accrual basis uses actuarial techniques and present value calculations to estimate the amounts of future payments to cover benefits earned during the period. The accrual basis assumes that employees earn retiree health benefits throughout their careers, not when they retire. Consequently, the employer is required to recognize (1) an expense in the amount of benefits earned by employees during the period of employment, regardless of when they are paid, and (2) a liability in the amount of benefits owed for the current period as well as portions of prior periods which remain unfunded.

FASB Statement 106 allows an employer who is changing from the pay-as-you-go basis of accounting for postretirement benefits to the accrual basis to amortize the cost of health care benefits earned prior to implementing the statement on a straight-line basis over a maximum of 20 years.

Appendix I contains a more detailed description of the characteristics of both types of plans.

Objectives, Scope, and Methodology

Our objectives were to determine (1) whether the Postal Service's use of the pay-as-you-go basis to account for the cost of postretirement health care benefits is appropriate and (2) the estimated effect the annual expense for the pay-as-you-go and accrual methods of accounting would have on rates for first class mail.

In order to determine whether the pay-as-you-go basis is appropriate, we reviewed FASB Statement 106 to identify the distinguishing features of (1) multiemployer and (2) single-employer and multiple-employer plans. We then compared these characteristics with the Postal Service's involvement and payment requirements under the FEHBP, which is administered by OPM.

To determine the potential effects of annual postretirement health care benefits expense on First Class postal rates, we (1) examined Postal

Service documents, such as the 1990 Annual Report of the Postmaster General and the related Comprehensive Statement on Postal Operations, the fiscal year 1991 audited financial statements of the Service, and legislation and other reports and (2) obtained the estimated annual expense that would be recognized under each method from a 1991 study that a private consulting firm performed for the Postal Service. We allocated 55 percent of postretirement health care costs to First Class Mail based on Postal Service's data which showed 55 percent of its costs were attributable to this class of mail.

We conducted our study in Washington, D.C., between March 1990 and January 1992, in accordance with generally accepted government auditing standards. The Postal Service comments on a draft of this report are presented and evaluated at the end of this report and in appendix II.

Pay-As-You-Go Accounting Is Appropriate, But Accrual Information Would Be More Complete

The Postal Service's participation in FEHBP meets the criteria of a multiemployer plan, and the pay-as-you-go basis is, thus, the proper accounting treatment for recognizing postretirement health care costs. However, estimated accrued information on these costs could be reported in a note to the Postal Service's financial statements which would provide users more complete information about the cost of postretirement health care benefits than the pay-as-you-go basis.

Participation in FEHBP Meets Criteria of Multiemployer Plan

The Postal Service and its independent auditors determined that the Service's participation in FEHBP meets substantially more characteristics of a multiemployer plan than a multiple-employer plan according to FASB Statement 106. For example, FEHBP provides health benefits to all federal employees and retirees and treats all such individuals as a single group rather than distinguishing among them by employer. The contributions received by FEHBP are based on the risk characteristics of groups of participants that are intended to be representative of all participants rather than those of any single employer. In addition, the benefits offered in the plan are under the control of OPM and the various insurance carriers rather than any of the federal employers and are equally available to all participants. The auditors further noted that the Postal Service's obligations for government contributions for retirees are obligations to OPM rather than to the individual retirees. Based on our own analysis, we agree with the Postal Service's assessment.

Projected Costs Differ Under the Pay-As-You-Go and Accrual Bases

If the current trend in medical costs continues, postretirement health care benefit costs are likely to increase substantially. However, the estimated annual costs recorded on the Service's financial statements will differ depending on whether costs are accounted for under the pay-as-you-go or accrual basis of accounting.

The Postal Service contracted with a private firm to calculate estimates of the postretirement health care costs that it would need to recognize under both the pay-as-you-go and the accrual bases from fiscal years 1994[3] through 2034. The estimates were prepared to assist the Postal Service in determining the proper application of FASB Statement 106. The amounts calculated were based on available OPM information and represented estimates of the annual costs that would be recognized as expenses in the Postal Service's statement of operations. Amounts were calculated in current dollars[4] and were intended to reflect full compliance with FASB Statement 106 under both the multiemployer plan and the multiple-employer or single-employer plan with either no funding (that is, no funds being set aside to pay for future costs) or full funding (that is, cash in the amount of the expense being invested in income-producing instruments and the earnings being used to pay future benefits).

The actuarial assumptions used under both bases included growth in medical costs and discount rates; employment termination, retirement, and mortality rates; replacement of terminated or retired employees; forecasted annual medical costs; and current and projected population statistics of retired Postal Service employees. The estimates assume that the Service continues to participate in FEHBP. Although we did not verify the assumptions and calculations, they seemed reasonable.

While the same actuarial assumptions and present value calculations were used in the computations under both bases, other assumptions differed. Under the pay-as-you-go basis, the estimated annual expense was based on FEHBP's projected cash needs to pay for the Postal Service's part of its retirees' health care costs each year during that 41-year period and the assumption that no funds had been set aside to pay for future costs. It was

[3]FASB Statement 106 is effective for fiscal years beginning after December 15, 1992. Therefore, FASB Statement 106 becomes effective for the Postal Service in fiscal year 1994, which begins on October 1, 1993.

[4]The term "current dollars" refers to the dollar value of a good or service at the time the good or service is sold. This is in contrast to the value of the good or service in constant dollars, which is adjusted for changes in prices.

also assumed that the Service would be required to pay those amounts in full each year during that 41-year period.

Using the accrual basis, two streams of annual expense were determined under two funding assumptions: full funding and no funding. For both funded and unfunded amounts, the annual expense was calculated by adding the items FASB Statement 106 identified and defined as components of the expense: (1) the estimated present value of postretirement health benefits earned during the current fiscal year, (2) the interest cost on the amount of future payments to be made (that is, accumulated benefit obligation) based on all benefits earned in prior periods, and (3) the current period's amortized amount of postretirement health benefits earned before October 1, 1993. Item 3 would be included for only 20 years (this is, fiscal years 1994 through 2013), since it is a transition period amount resulting from the implementation of FASB Statement 106 to account for benefits earned by employees prior to October 1, 1993. Everything else being equal, the postretirement health benefit expense could be expected to decrease at the end of the 20-year amortization period.

Under the scenario in which annual expenses are fully funded, cash in the amount of the annual expense was assumed to be invested by the Postal Service in income-producing securities or investment accounts, from which the earnings would be restricted to paying future health benefit premiums. Thus, the fully funded expense would equal the sum of the three previously mentioned cost components minus the estimated amount of earnings on invested funds. The unfunded accrual expense would not contain a deduction for estimated earnings.

Table 1 contains the estimates of the Postal Service's postretirement health care costs for fiscal years 1994 through 2034 under both the pay-as-you-go and accrual basis of accounting (no funding and full funding), as reported by the private firm to the Postal Service.

Table 1: Estimated Annual Postretirement Health Care Costs of the Postal Service, Fiscal Years 1994 Through 2034, in Current Dollars

Dollars in millions

Fiscal year	Multiemployer plan (pay-as-you-go basis)	Multiple-/single-employer plan (accrual basis)	
		No funding	Full funding
1994	$405	$4,800	$4,800
1995	472	5,115	5,115
1996	553	5,461	5,052
1997	645	5,826	5,013
1998	750	6,219	5,005
1999	866	6,635	5,020
2000	997	7,077	5,061
2001	1,142	7,548	5,127
2002	1,306	8,040	5,209
2003	1,488	8,544	5,296
2004	1,695	9,064	5,392
2005	1,928	9,598	5,495
2006	2,188	10,157	5,614
2007	2,477	10,735	5,743
2008	2,800	11,305	5,809
2009	3,168	11,889	5,973
2010	3,586	12,504	6,110
2011	4,041	13,144	6,261
2012	4,536	13,807	6,423
2013	5,079	14,502	6,605
2014	5,654	15,211	6,785
2015	6,242	14,517	5,548
2016	6,848	15,236	5,823
2017	7,476	15,972	6,094
2018	8,125	16,720	6,354
2019	8,794	17,483	6,609
2020	9,535	17,909	6,503
2021	10,301	18,366	6,440
2022	11,093	18,810	6,368
2023	11,907	19,244	6,291
2024	12,735	19,661	6,205
2025	13,656	19,879	5,925
2026	14,592	20,193	5,764
2027	15,865	20,467	5,577
2028	17,142	20,660	5,323
2029	18,440	20,756	4,992
2030	20,061	20,748	4,584
2031	21,590	20,657	4,125

(continued)

Dollars in millions

Fiscal year	Multiemployer plan (pay-as-you-go basis)	Multiple-/single-employer plan (accrual basis)	
		No funding	Full funding
2032	23,063	20,404	3,560
2033	24,314	19,988	2,858
2034	25,517	19,415	2,056

It shows that the estimated annual expenses under the pay-as-you-go basis increases each year during the 41-year period. In contrast, the estimated expenses under the accrual basis, full funding, peak in 2019 at $6,609 million and then decrease in each succeeding year. In addition, during the first 21 years (through 2014), the estimated annual expense under the pay-as-you-go basis is less than under the accrual basis with full funding. However, in 2015 this relationship is reversed and the estimated annual expense under the pay-as-you-go basis becomes increasingly higher than under the fully funded accrual basis.

In commenting on a draft of this report, officials of the Service's Department of the Controller stated that estimates in constant dollars (that is, estimates adjusted for inflation) would yield significantly lower figures. However, the relationship between the pay-as-you-go and accrual amounts in constant dollars will be similar to the relationship in current dollars. We presented current dollar amounts because we believe use of current dollars provides a better illustration since it more vividly reflects the estimated funding requirements and rate changes that may be necessary. In addition, the amounts presented are consistent with the figures the private firm developed for the Postal Service for its use in applying FASB Statement 106.

Accrual Information Shows Full Costs and Future Obligations

Although the pay-as-you-go basis is the proper accounting treatment for recognizing the Postal Service's postretirement health care costs under the requirements of FASB standards, information on estimated accrued benefits could be reported in a note to the Service's financial statements. Additional information could include a description of the plan and, based on OPM data, the estimated amounts of benefits employees earned during the period reported as well as those amounts employees and retirees earned in prior periods for which future payments will be required. Disclosing such information in a note could help statement users (that is, the Congress, the Executive Branch, the Postal Rate Commission, and the public) assess the total costs the Postal Service incurred and the estimated amounts of future payments that the Service will be required to make to FEHBP.

In fiscal year 1994, for example, the Postal Service would, under the pay-as-you-go basis, report about $405 million as postretirement health care expense and no liability (or a liability for the unpaid portion of the estimated $405 million, if any). Consequently, the full costs of benefits employees of the Postal Service earned during fiscal year 1994 would not be shown as an expense; only the amount the plan billed during that year would be shown. Further, the cost of benefits employees and retirees earned prior to October 1993 would not be included.

However, under the accrual basis, $4.8 billion would be recognized as an expense and would represent the amount earned and attributed to fiscal year 1994. Any unfunded portion of the estimated $4.8 billion would be reported as an unfunded liability. In addition, the notes to the statements would have to disclose the amounts of benefits earned in prior periods that remain unamortized (that is, not yet recognized as an expense).

Funding Decisions and Cost Control Efforts Could Affect Rates

Officials of the Service's Department of the Controller told us that the Service intends to pay for postretirement health care costs from current revenues. The Service has some cost control efforts underway and is exploring other options to help meet rising costs, of which postretirement health care costs is a component. Nevertheless, based upon our analysis of estimated costs, we believe that some rate increase will probably be necessary.

Funding Decisions Following the Pay-As-You-Go and Accrual Bases of Accounting Could Affect Rates Differently

Requesting rates changes is largely a financial management policy matter. The Postal Service can request rate increases as needed since the Postal Reorganization Act requires the Service to break even by recovering essentially all costs from the users of its services. Officials of the Service's Department of the Controller stated that the Service generally files for rate increases to recover costs over a 3-year cycle.

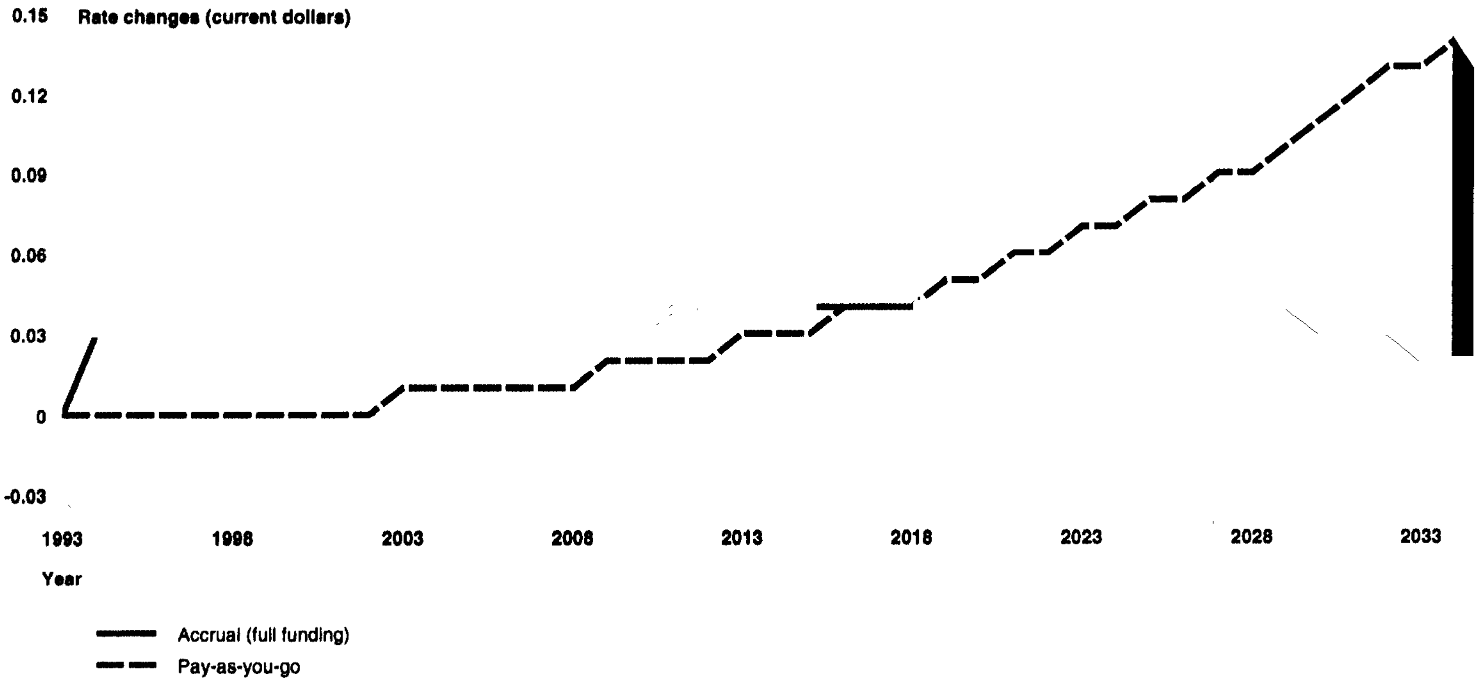
For illustration purposes only, we are providing our analysis of how rates might be influenced if funded under (1) the pay-as-you-go approach and (2) the accrual basis of accounting.

To do this, we estimated the projected rate increases for First Class Mail that would be necessary to fund a relative portion of postretirement health care costs under both the pay-as-you-go and the full funding accrual bases from 1994 through 2034.[5] According to Service officials, about 55 percent of the total cost of the Postal Service is attributable to First Class Mail. For this reason, we applied 55 percent of the increase in postretirement health care costs to that class of mail. The remaining 45 percent of the increase in this cost would require rate increases in other classes of mail. We assumed that all of the costs would be covered through new revenues. Our estimates were based on the projected annual postretirement health care costs appearing in table 1 and the Postal Service assumption that a 1-cent increase in postal rates (per piece of First Class Mail), has historically generated revenue of about a $0.8 billion to $1 billion annually. All increases are in current dollars.

Our estimates show that as a result of projected increased postretirement health care costs, rates per piece of First Class Mail could increase by about 2 cents to 14 cents, depending upon the funding basis used over the 41-year period. As shown in figure 1, the pay-as-you-go basis would require less of an increase in the short run, needing only a 1-cent increase in 2003; in contrast, the accrual basis would require an estimated 3-cent rate increase immediately in 1994. However, in the long-term, the fully funded accrual basis would require only an estimated additional 1-cent increase in 2011, and a 2-cent decrease thereafter through 2034, resulting in only a net 2-cent increase over the 41-year period. However, the pay-as-you-go approach could require an estimated additional 13-cent increase over the same period.

[5]Accruing expenses, but not funding them would result in rate pressures similar to those estimated for pay-as-you-go accounting treatment.

Figure 1: Projected Rate Changes Per Piece of First Class Mail Based on Projected Annual Postretirement Health Care Expenses



Officials of the Service's Department of the Controller caution that despite the Postal Service's monopoly on First Class Mail, an increase in rates may not result in a corresponding increase in revenues. Higher rates may reduce the quantity demanded for the services offered by the Postal Service, and thus revenues may fall short of anticipated amounts and below costs. This would create additional upward pressure on rates.

Cost Control Efforts

The Postal Service is exploring several options to reduce operational and health care costs. If successful, these efforts may help reduce the need for rate increases. In fiscal year 1990, salaries and related compensation benefits comprised about 84 percent of the Postal Service's total expenses. Because this percentage is so large, the Postal Service has identified the growth of labor and related costs (including postretirement health care costs) and the need to increase productivity as top priorities in helping to control rates. In testimony on February 7, 1990 before the Committee on the Postal Service and Civil Service, House of Representatives, (GAO/T-GGD-90-16), we concurred with the Postal Service that these initiatives were appropriate targets for cost control measures. We are currently studying the extent to which its automation efforts have achieved savings.

Conclusions

We agree with the Postal Service and its independent auditors that pay-as-you-go is the proper accounting method for postretirement health care benefits under FASB Statement 106 requirements. However, full disclosure of future liabilities based on the best available OPM information would provide statement users more complete information for making informed judgments about the Postal Service in dealing with oversight matters, assessing rate change requests, and evaluating performance.

Postal rate increases will probably be needed in both the short term and long term to fund rising postretirement health care costs, regardless of which basis of accounting is used. Rates will increase more dramatically in the short term if the fully funded accrual basis is selected as the basis to fund postretirement health care benefits. However, the long-term rate of increase will be substantially less using the full funding accrual basis.

Recommendations

We recommend that the Postmaster General direct the Assistant Postmaster General, Department of the Controller, to provide a note to the financial statements which, at a minimum, describes the postretirement health care benefits plan, the estimated amounts of postretirement health care benefits earned by employees and retirees since July 1, 1971, to the date of the statements less the related amounts of benefits used, the estimated amounts of benefits attributable to the period(s) covered by the statements, and the assumptions under which the estimates were derived.

Agency Comments and Our Evaluation

The Service disagreed with our recommendation that accrual information (that is, the full amount of benefits earned by Service employees and retirees requiring future Service payments) be disclosed in a note to the financial statements. They told us that such note disclosure would confuse financial statements users by blurring the distinctions made by the FASB between accounting for postretirement health care costs under a multiemployer plan and under a multiple- or single-employer plan.

We believe that the disclosure of accrual information would enhance the usefulness of the statements and is not inconsistent with the Service's reporting of postretirement health care costs on a pay-as-you-go basis in the body of the financial statements. Adding the accrual information in the notes to the financial statements would highlight the total amount of postretirement health care benefits earned up to the date of the statements, less estimated amounts used by Service employees and retirees who participate in FEHBP. These disclosures represent future payments the Service will be required to make to the FEHBP. Also, disclosure of this accrual information in a note in the Service's financial statements is not precluded by FASB Statement 106, and hence is not inconsistent with GAAP.

We are sending copies of this report to the Acting Postmaster General, the Director of the Office of Management and Budget, the Director of the Office of Personnel Management, the Director of the Congressional Budget Office, the Chairmen of the House and Senate Budget Committees, the Ranking Minority Member of the Senate Budget Committee, and other interested congressional committees. Copies will be made available to others on request.

This report was prepared under the direction of Bruce Michelson, Senior Assistant Director, Accounting Policy Group, who may be reached at (202) 275-9578 if you or your staff have any questions. Other major contributors to this report are listed in appendix III.

Sincerely yours,

Donald H. Chapin

Donald H. Chapin
Assistant Comptroller General

Contents

Abbreviations

FASB	Financial Accounting Standards Board
FEHBP	Federal Employees Health Benefit Plan
GAAP	generally accepted accounting principles
GAO	General Accounting Office
OBRA	Omnibus Budget Reconciliation Act
OPM	Office of Personnel Management

Summary of Characteristics of Postretirement Health Care Plans Contained in FASB Statement 106

The accounting treatment required by FASB Statement 106 for postretirement benefits depends upon the employer's plan type. Two basic types have been identified: (1) the multiemployer plan, which requires the pay-as-you-go basis of accounting, and (2) the multiple-employer or single-employer plans, which require the accrual basis of accounting. FASB Statement 106 identifies several characteristics to be considered when determining the plan type. This appendix summarizes the more important characteristics.

Multiemployer Plans

A multiemployer postretirement benefit plan is generally defined as a plan to which two or more unrelated employers contribute pursuant to a collective bargaining agreement. Employers participating in multiemployer plans usually have a common industry bond or, if employers come from different industries, their employees' labor union may constitute their common bond.

A plan is considered a multiemployer plan if a participating employer does not exercise complete or significant control over (1) the selection of insurance carriers, (2) the benefits available to its employees and retirees (which determine the carriers' risks and rates), (3) the resulting costs it incurs, and (4) the assets it contributes to the plan. These assets may be used to provide benefits to employees of other employers since the assets are not segregated in a separate account or restricted to provide benefits only to employees of the contributing employer. Also, events affecting employees of one employer can affect the benefit obligation of all participating employers.

In accordance with the collective bargaining agreement, the plan administrators establish the benefits to be received, contract with insurance carriers, and determine the amounts of contributions to be paid by participating employers. Since the plan is liable for providing benefits to employees and retirees of participating employers, FASB Statement 106 requires the pay-as-you-go basis of accounting. Participating employers are to recognize as an expense only that amount which they are required to pay into the plan during a given accounting period, and a liability is to be recognized only for unpaid contributions required for that period. No other liability for postretirement health care cost is to be recognized.

Multiple-employer or Single-employer Plan

A single-employer postretirement health benefit plan is maintained by one employer. A multiple-employer plan is generally not collectively bargained but is intended to allow participating employers to pool assets for investment purposes and to reduce the cost of plan administration. Separate accounts for each employer are maintained within multiple-employer plans so that contributions provide benefits only for employees of the contributing employer. Multiple-employer plans are, in substance, aggregations of single-employer plans.

As opposed to multiemployer plans, single-employer plans allow the sponsoring employer control over (1) the selection of insurance carriers, (2) the selection of benefits available to its employees and retirees (which determine the carriers' risks and rates), (3) the resulting costs it incurs, and (4) the assets it contributes to the plan. Events affecting employees of one employer will not affect other employers' benefit obligations.

Since an employer, and not the plan, is liable for providing benefits to its employees and retirees, FASB Statement 106 requires the accrual basis of accounting. Employers participating in a multiple-employer plan or sponsoring a single-employer plan are to consider several items in calculating current year expense: (1) the estimated present value of postretirement health benefits earned during the current period, (2) interest on the amount of future payments to be made (that is, accumulated benefit obligation) based on all benefits earned in prior periods, (3) the current period's amortized amount of postretirement health benefits earned before implementation of FASB Statement 106 requirements, and (4) projected annual earnings on investments. Item 3 represents 1/20 of the amount of total postretirement health care benefits earned in prior years by current employees and retirees since FASB Statement 106 established a 20-year transition period to amortize the cost of prior year benefits. The first three estimates are added together and the fourth is subtracted to arrive at the current period expense.

In addition to the expense, a liability must be recognized for the cumulative unfunded expense recognized in the current and prior periods. Further, the employer is required to disclose in the notes to the financial statements the total amount of postretirement health care benefits earned by employees in the current and prior periods, including the unamortized amounts.

A primary reason for requiring accrual accounting for multiple-employer or single-employer plans is that the obligation for future health benefits is a liability to the employer and should be recorded as such. FASB Statement

106 views the "exchange" between employees and the employer as a critical criterion qualifying the obligation as a liability. In exchange for the services rendered by an employee, the employer promises to provide not only current wages and other current and deferred benefits, but also health care during the employee's retirement period. Postretirement benefits (including health care benefits) are not gratuities but rather are part of the employee's compensation for services rendered. The obligation for that compensation is incurred by the employer when the services exchanged for that benefit are rendered, not when the employee retires.

Comments From the U.S. Postal Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

THE DEPUTY POSTMASTER GENERAL
Washington, DC 20260-0050

March 27, 1992

Dear Mr. Chapin:

Thank you for providing us an opportunity to comment on the draft report entitled, Financial Reporting: Accounting for the Postal Service's Postretirement Health Care Costs. We agree with your finding that the Postal Service's participation in the Federal Employees Health Benefit Plan (FEHBP) meets the criteria of a multiemployer plan and that, under the Financial Accounting Standards Board (FASB) Statement 106, the pay-as-you-go basis is the proper accounting treatment for recognizing postretirement health care costs. We do not believe, however, that inclusion of accrued benefit costs in a note to the financial statement is either practicable or advisable. The suggested disclosure is inconsistent with the FASB's position that disclosures for participants in multiemployer plans should be different from those participating in single or multiple employer plans. The GAO proposal would blur that distinction. We have discussed this matter with our independent auditors, Ernst & Young, who also believe that inclusion of such a note would unnecessarily confuse readers as to why the Postal Service is participating in the FEHBP on a multiemployer basis while presenting financial position data on a single or multiple employer plan basis.

See comment 1.

While we agree that alternative accounting treatments for postretirement health care costs will have an impact on future postal rates, we suggest that the report would present a more accurate picture of the Postal Service's operating environment by recognizing that other factors, such as changes in demand patterns for services as well as changes in mail volumes, affect future rates as significantly as do costs.

See comment 2.

In the analysis of the effect of postretirement health care cost accruals on future postal rates, the report attributes 100 percent of such costs to First-Class postage rates. This deviates from our standard method of allocating indirect costs to all classes of mail. Accordingly, an increase in an indirect cost would produce across-the-board rate increases in all classes of mail. In Fiscal Year 1991, First-Class Mail accounted for about 55 percent of mail volume and attributable costs. In the existing mail-mix environment, a cost increase allocated to all classes of mail would result in only about one-half the impact on First-Class Mail rates as compared with the report's 100 percent allocation method.

See comment 3.

The estimates of projected costs for Fiscal Years 1994 through 2034 (Table 1) were prepared to give us a very rough estimate of the magnitude of these potential future costs. If this information is presented in the report, it should be accompanied by appropriate disclaimers as to the nature of the estimates. While many of the assumptions upon which these estimates were based are reasonable representations of recent experience, when extrapolated over a 40-year period, the margin of error becomes so great that the latter year estimates are essentially meaningless. The tabular format itself tends to imply a greater degree of precision than actually exists. We further believe that any long-range projections, such as those in Figure 1, should be done on a real dollar basis. Even at a moderate inflation rate, a current dollar basis, as used in the report, can be seriously misleading about the true economic consequences of either payment stream.

See comment 4.

See comment 5.

In addition, the report does not reflect our position regarding the measurement of these costs on a constant dollar basis. In real dollars, the cost of a pay-as-you-go approach will probably be lower than prefunding. This conclusion is based on a number of economic assumptions but is consistent with our experience that costs increase at a higher rate than can be recouped by the return which can be achieved on Treasury securities. The results (and the conclusions of a reasonably sophisticated reader) are significantly different in constant dollars. We strongly believe that constant dollar information needs to be included in the report.

See comment 6.

We suggest that a section be added to the report that discusses the cumulative cost to postal ratepayers of an immediate five- to seven-cent rate increase as compared with a 24-cent rate increase spread over 40 years. Due to the timing of the rate increases, prefunding could actually result in higher real costs to ratepayers than pay-as-you-go funding. Further, we suggest that Figure 1 be accompanied by an explanatory note that the graph shows only the effect that the two funding alternatives could have on First-Class postage rates and does not take into account normal inflationary pressures.

See comment 3.

The report's conclusion that the long-term rate of increase in postal rates will be lower if postretirement health care costs are accrued and prefunded is correct only in current dollar terms. As noted, the real dollar costs to ratepayers would be higher using the accrual basis.

See comment 6.

We appreciate the opportunity to review and comment on the report. If you wish to discuss any of my comments, my staff is available at your convenience.

Sincerely,

Michael S. Coughlin

Mr. Donald H. Chapin
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The following are GAO's comments on the U.S. Postal Service's letter dated March 27, 1992.

GAO Comments

1. The Postal Service response is discussed in the "Agency Comments and Our Evaluation" section of this report.

2. As mentioned in the report, mail volume may diminish in response to rate increases. Our recent report, "U.S. Postal Service: Pricing Postal Services in a Competitive Environment," (GAO/GGD-92-49), March 1992, notes that there is considerable disagreement concerning the extent to which the volume of each class of the several classes of mail would decline in response to a rate increase. Factoring in the impact of declining mail volume would complicate our analysis without changing our overall conclusion. Therefore, we retained a simplified assumption that mail volume would remain essentially unchanged.

3. The report has been modified to show rate changes to First Class Mail based on allocating 55 percent of the increase in costs to that class of mail. The related graph has been modified to show the effects on rates, both increases and decreases, of First Class Mail based on the estimated 55 percent of cost allocated to that class.

4. Long-term projections are inherently uncertain. However, projections of estimated costs covering long-term periods similar to the one presented in our report and made with similar assumptions are not uncommon in accounting for pensions and postretirement health care benefits in both the private and governmental sectors.

5. We have modified the report to state that a parallel analysis using constant dollars would yield significantly lower figures and to state the reason why we showed current dollars. Use of current or constant dollars will not change the relationship of amounts between the pay-as-you-go and accrual basis.

6. We agree that, in constant-dollar terms, the sum of the annual undiscounted expenses under the pay-as-you-go basis at the end of the 41-year period covered by the analysis would be less than under the fully funded accrual basis. However, the undiscounted sum under the pay-as-you-go basis would exceed the sum under the fully funded accrual basis within a few years after the 41-year period covered by the analysis. Nevertheless, this is not a present value (discounting) analysis. In the

present value terms, the cost of the pay-as-you-go basis would be the same as the cost of the fully funded accrual basis.

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