

► Health

Accounting for Postretirement Benefits: Early Adopters of SFAS 106

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► A study of companies that adopted SFAS 106 early reveals the companies generally have not funded retiree health benefits. *The timing of a firm's adoption of the accounting standard is affected by a number of variables specific to that firm.* ◀

After more than ten years of study, the Financial Accounting Standards Board (FASB) issued the Statement of Financial Accounting Standards (SFAS) 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," in December 1990. For profit making firms with more than 500 employees, the rule took effect for fiscal years starting after December 15, 1992. Pertinent viewpoints and critical analysis on the effects and actions of individual employers have been plentiful in all forms of public media. This article focuses on the actual responses of companies that adopted the standard before the mandated date. The early adoption of a standard that reduces reported net income and has dramatic negative effect on the financial worth of the firm requires study. What are the characteristics of such companies and what are their motivations?

Under SFAS 106, the companies can choose not only the year in which they adopt the standard but also the actuarial assumptions and timing for recognition of the past service liability. The specific selection of actuarial assumptions may cause an under- or overstatement of the retiree health liability, permitting managers to smooth present and future income reports. The decision to recognize the full liability immediately rather than spread it over up to 20 years, as the standard allows, may be tied more to the effect on the firm's total financial performance for a particular year than on any aspect of the retiree health standard.

The evolution and the technical aspects of the accounting rule are discussed first. Next, data collected from financial statements and the appropriate footnotes demonstrate the actions and responses of the companies; previous studies have utilized only theoretical data. The possible motivations for early adoption are discussed. Finally, the empirical results of testing various hypotheses that might differentiate the early adopters from the later ones are presented and demonstrate important firm-specific variables.

BACKGROUND

The appropriate accounting treatment for postretirement health benefits has been of concern to FASB for some time.¹ In 1979, FASB issued an exposure draft of an SFAS that would have required disclosure of information about such ben-

efits. FASB believed such costs were significant and a standardized accounting treatment was needed to provide full disclosure of a company's financial position. That SFAS was not adopted. Between 1981 and 1984, FASB issued several discussion memoranda and a preliminary views document. The substantial discussion of these documents that followed included varying viewpoints, such as: Most "other postemployment benefits"

"The actuarial present value of all future postretirement benefits expected to be paid after retirement to the employee and his or her dependents is the *expected postretirement benefit obligation (EPBO)*."

(OPEBs) were similar to pensions and should be treated the same; the costs of accounting for OPEBs would exceed the benefit of the additional information; the employer's obligations for OPEBs were different from those for pensions and should not be treated the same; the costs of OPEBs were immaterial and the cash method provided adequate information; OPEBs were not directly related to service. Finally, in February 1984, FASB separated consideration of OPEBs from its work on pension accounting because of the complexity of the issues and the need to clearly identify the pertinent aspects of accounting for OPEBs. After additional discussions, SFAS 81 was issued in 1984, requiring a description in the financial statements of the postretirement benefits provided, their funding, the current costs (pay as you go) and anything else that significantly affected their comparability. This information was to be provided for periods ending after December 15, 1984. Immaterial items were not included. If the postretirement benefit costs were not available separately from the benefit costs for active employees, then total costs could be shown. If the employers could not otherwise provide the cost information, "the Board encourage[d] employers to use reasonable methods to

approximate the costs recognized for retirees' benefits."² SFAS 81 did not cover any measurement or recognition issues. In 1987, FASB Technical Bulletin No. 87-1 responded to the question of how to treat a change in the accounting method used for OPEBs, if an employer made such a change, by stating that the employer either could amortize the amount forward or could recognize the change in the year of change.³

FASB issued an exposure draft on postretirement benefits in February 1989. After additional public comment and discussion, FASB finally, in November 1990, issued SFAS 106, which requires a change to the accrual accounting method for postretirement benefits for most companies in the accounting period beginning after December 15, 1992.

SFAS 106 "... applies to *all* postretirement benefits expected to be provided by an employer to current and former employees ... their beneficiaries, and covered dependents..."⁴ It "... does not apply to pensions or life insurance benefits provided through a pension plan."⁵ It treats postretirement benefits as part of an employee's current pay, which must be accounted for in the current period. The present value of the future benefits is the measure of the current obligation. Therefore, the employer's annual postretirement benefit expense (net periodic postretirement benefit cost) under the accrual method is made up of the following factors: annual service cost,⁶ interest cost,⁷ actual return on plan assets, amortization of changes in the assets or the calculation of the obligation⁸ and amortization of changes in the plan design.⁹

Since companies had postretirement benefit plans in existence before SFAS 106, the change to the accrual method requires the recognition of the past service liability. As of the date the standard is initially adopted, the present value of this past service obligation or transition obligation is the difference between the accumulated postretirement benefit obligation and the plan's funded amount.¹⁰ This transition obligation may be immediately recognized or amortized over up to 20 years.

The actuarial present value of all future postretirement benefits expected to be paid after retirement to the employee and his or her dependents is the *expected postretirement benefit obligation (EPBO)*. The *accumulated postretirement benefit obligation (APBO)* is the actuarial present value of future postretirement benefits based on

FIGURE 1

an employee's service up to the current date. When an employee becomes fully eligible for postretirement benefits, the EPBO and APBO are equal: prior to that time the APBO is the portion of the EPBO due to past service. The change to the accrual method requires recognition of all the APBO to date. Figure 1 illustrates this.

The amount of accrued expense will be affected by employee demographics, plan design and actuarial assumptions. Extensive disclosures of the factors used in the calculations are required in the footnotes to the financial statements. Health benefits represent the largest portion of postretirement benefits expense of most companies, although many companies lump postretirement life insurance with the health benefits. While SFAS 106 has a not-later-than-required adoption date, employers could choose to adopt prior to that date.

As employers are not required to set aside any money at the time they charge these benefits against income, most postretirement benefits are not funded. This means that currently the charges do not affect cash flow—only the benefits actually paid during the year do. This amount may be more or less than the expense charged against income for the year. The net periodic benefit expense, including all of the items discussed above, will generally appear on the income statement (in some businesses, a portion of this expense may have to be capitalized in inventory and included in assets on the balance sheet). The difference between the annual expense and the postretirement benefits actually paid during the year will be added to the liability for postretirement benefits on the balance sheet. Should the cash payments in a year be larger than the net periodic benefit expense, the accrued liability would be reduced. By making this a recognized claim against the company, it reduces the amount that is available to be paid to shareholders as dividends.

To see what the actual costs of the postretirement benefits are, rather than what was forecast, the financial statements, including the footnotes, from annual reports for fiscal years ending be-

tween June 1991 and June 1992 were obtained from October 1992 CD-DISCLOSURE. This database includes 12,000 public companies that filed reports with the Securities and Exchange Commission in the 18 months prior to October 1992. To be included, companies must have at least 500 shareholders of one class of stock and assets of at least \$5 million. The database, when searched for "postretirement benefits" or "FAS 106" in the footnotes, produced 1,342 companies. Of these companies, 13 had adopted SFAS 106 prior to the period under study; 120 had no postretirement benefits; 29 had canceled their postretirement benefits; 344 had postretirement benefits that they said were not material; 775 had benefits that they said would have a significant effect on their financial statements, but they were not adopting SFAS 106 at that time; and 61, which are the focus of this study, had actually adopted the standard. This small number is similar in size to early adopters of other FASB standards.

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TABLE I

Sample by Industry

<u>Category</u>	<u>SIC Numbers</u>	<u>Number of Companies</u>	<u>Percentage of Companies</u>
Mining & Construction	(1000-1798)	6	9.8%
Food & Tobacco	(2000-2199)	2	3.3
Textile & Apparel, Lumber, Furniture & Fixtures	(2200-2599)	2	3.3
Paper & Printing Mfg.	(2600-2799)	7	11.5
Chemical & Rubber	(2800-3099)	5	8.2
Leather & Stone Mfg.	(3100-3299)	3	4.9
Metal Mfg.	(3300-3499)	7	11.5
Machinery & Equipment Mfg.	(3500-3999)	11	18.0
Transportation, Pipelines, Transportation Services, Communications	(4000-4899)	3	4.9
Public Utilities	(4900-4999)	2	3.3
Wholesale Trades	(5000-5199)	3	4.9
Retail Trades	(5200-5999)	6	9.8
Other	(6000+)	4	6.4

TABLE II

Sample by Number of Employees

<u>Number of Employees</u>	<u>Number of Companies</u>	<u>Percentage of Companies</u>
100-999	4	6.6%
1,000-9,999	27	44.3
10,000-29,999	16	26.2
30,000-59,999	6	9.8
60,000-99,999	2	3.3
100,000-299,999	5	8.2
Over 300,000	1	1.6

TABLE III

Sample by Total Assets

<u>Percentage</u>	<u>Number of Companies</u>	<u>Percentage of Companies</u>
Under 50 million	1	1.6%
50 to 100 million	1	1.6
100 to 500 million	15	24.6
500 million to 1 billion	7	11.5
1 to 5 billion	21	34.4
5 to 10 billion	4	6.6
10 to 50 billion	10	16.4
50 to 100 billion	1	1.6
Over 100 billion	1	1.6

In the following sections we first describe the characteristics of the early adopting companies, the discount and medical trend rates they used and the effect of the change to the accrual method on their annual costs. Then we discuss possible motivations for companies to adopt the standard before required. And finally, we report the results of our empirical tests of these motivations.

CHARACTERISTICS

Manufacturing businesses made up more than 60% of the sample. The rest were from various industries. This was not unexpected as manufacturing companies had the largest number of both under 65 retirees and age 65 and over retirees with their own employment-based health insurance (Zedlewski 1993). Table I shows the industry composition of the group.

Of the 61 companies, the median firm had between 1,000 and 9,999 employees. An additional quarter of the firms had between 10,000 and 29,999 employees with only four below 1,000 workers. Again, this was a somewhat expected result, as the August 1988 Current Population Survey showed that 72% of retirees who worked for firms with more than 1,000 employees had employment-based health coverage (Zedlewski 1993). (See Table II.) Early adopters were also most likely to be in the middle range of companies in terms of dollars of assets, as Table III shows.

Total accumulated postretirement benefit obligation (APBO) among this sample was \$20.8

billion, with funding of \$3.7 billion by nine of the companies. The low level of funding is not surprising: There are no vesting and funding requirements. Furthermore, the Deficit Reduction Act of 1984 (DEFRA) restricted the amount of contributions that are tax deductible and taxed as unrelated business income the earnings of trusts set up to fund these benefits.

In a theoretical study of 676 large firms in 1989, (Warshawsky 1992), the accumulated postretirement obligation was estimated at an average of 31% of the net worth of a company. The results of our study show that the obligation of a majority of the early adopters are below this figure (Table IV). The median APBO is 5-10% of net worth; 79% of the companies have an APBO of 15% or less. Only three companies have an APBO of 50% or more.

In estimating the APBO, a company must adopt some discount rate to determine the present value of the benefits and a medical trend rate to determine the future cost of the benefits. A higher discount rate produces a lower obligation and expense. The figures used by the 61 companies in this study are presented in Table V and Table VI. There was not much variation in the discount rate used by industry, and the overwhelming majority used the same discount rate in the valuation of their pension plans as in the retiree health plan. In establishing the discount rate, SFAS 106 required employers to look at rates of return on high-quality fixed income investments such as those rated by Moody's as Aa or Aaa. At the middle of 1992, these were just over 8.5%.¹¹ Almost a quarter of the sample in our study used a higher discount rate to reduce their measured obligation.

The medical trend rate used varied widely, as shown in Table VI. This rate is determined by considering estimated medical care inflation, projected changes in health care utilization, the projected changes in the health status of participants and projected technological advances. These assumptions are difficult to estimate accurately and will vary from company to company. The beginning rate commonly used was the current rate assumed in the employer's health care plan for active employees, generally assumed to decrease over time. The declining rate presumably was based on an assumption that health costs cannot continue to increase at the present rate relative to the Gross National Product (Akresh et al. 1990).

TABLE IV

***Accumulated Postretirement Benefit Obligation/
(Equity Plus Net Transition Charge)***

<u>Percentage</u>	<u>Number of Companies</u>	<u>Percentage of Companies</u>
0-5%	18	29.5%
5-10	17	27.9
10-15	13	21.3
15-20	4	6.6
20-50	5	8.2
50-60	3	4.9
Negative Equity	1	1.6

TABLE V

Discount Rates

<u>Discount Rate</u>	<u>Number of Companies</u>	<u>Percentage of Companies</u>
7.5 %	5	8.2%
7.6-8.0	18	29.5
8.1-8.5	23	37.7
8.6-9.0	12	19.7
9.1-9.5	2	3.3
None Shown	1	1.6

TABLE VI

Medical Trend Rates

	<u>Low</u>	<u>Median</u>	<u>High</u>
Present Rate	8-8.9%	14-14.9%	17-18.5%
Future Rate	5-6%	6-7%	9-10%
Number of Years to Future Rate	1-10 yrs.	11-15 yrs.	50+ yrs.

An understated trend rate in the early years produces an understated APBO. The data show great variance and some cause for alarm because of possible future earnings manipulations. Therefore, companies were required to disclose the effect of a 1% change in the medical trend rate. While the data were presented in different formats, Ta-

TABLE VII**Effect of 1% Increase in Medical Trend Rate**

Percentage Increase in APBO	Number of Companies	Percentage of Companies
Over 20%	2	3.3%
16-20	4	6.6
11-15	22	36.1
5-10	24	39.3
0-5	5	8.2
No Value	4	6.6

TABLE VIII

**Accumulated Postretirement
Benefit Obligation Retirees/
Total Accumulated Postretirement
Benefit Obligation**

Percentage	Number of Companies	Percentage of Companies
Less than 10%	1	1.6%
10-20	1	1.6
20-30	2	3.3
30-40	6	9.8
40-50	5	8.2
50-60	17	27.9
60-70	10	16.4
70-80	9	14.8
80-90	0	0.0
90-100	5	8.2
Not Available	5	8.2

ble VII shows the results expressed as the effect on APBO. The majority of companies expect an increase of 1% in the medical trend rate to increase the APBO by 5-15%.

The maturity of the group is another characteristic that would affect the impact of the required standard. Before compliance, the current retirees' health care costs were reported using a pay-as-you-go method. The increase in the annual cost under the accrual method is greater for groups that have few current retirees relative to future retirees. While the number of people in each of the three employee groups (active employees not yet eligible, active employees eligible and retired employees) are not disclosed in

the financial statements or in the footnotes, the dollar amount for each category was provided and, therefore, the percentages of the APBO allocated to the retirees may be calculated. This is shown in Table VIII.

The ratio of APBO for retirees to total APBO will be affected by the richness of the plan, the actuarial assumptions used and any plan design changes limiting benefits for future retirees. Nevertheless, much of the early adopters' liability seems likely to be for current retirees (Akresh et al. 1990). The increase in annual costs from pay as you go to an accrual method are shown in Table IX. The expense for immediate recognition of the transition obligation (similar to past service liability of a pension) is not recognized as an annual cost in this table. Firms with higher numbers of current retirees to future retirees will have lower rates of increase over the amount that they are paying immediately before the adoption. The data give evidence that many of the early adopters were mature groups.

A field study of 25 major companies by Coopers & Lybrand (Dankner et al. 1989) for the Financial Executives Research Foundation estimates that the most mature firms with fewer than two actives per retiree will experience, under the accrual method, annual costs 2.6 times pay-as-you-go expense. The immature firms with more than six actives per retiree will see annual costs increase 6.3 times. The majority of the companies in our study showed ratios below this.

In a small prototype study for the National Association of Accountants (Akresh et al. 1990) of valuation of ten firms, mature firms produced ratios of two to seven times the current cost. Using this definition of maturity, 91% of the above sample would qualify as mature.

While these characteristics generally describe the early adopters, they do not necessarily explain why these companies chose to adopt SFAS 106 before FASB's mandatory date, or why other companies did not. This question of motivation is discussed next.

MOTIVATIONS FOR EARLY ADOPTION

While the trade literature stressed the time needed to gather data necessary to make SFAS 106 computations and to redesign and/or eliminate benefits to lower the yearly expense and accrued liability, other factors—size, maturity and the company's prospective credit rating—

may also influence a company's decision to adopt SFAS 106 accounting rules relatively early. Large companies, such as those in the sample, are more likely to use consultants and to generate more internal data; consequently, they may have the information necessary to proceed early to adopt the standard. As court rulings have made it very difficult to eliminate or reduce health benefits for the already retired, mature companies cannot change their plans to affect the amount of the liability. Finally, analysts are generally not concerned about the effect of SFAS 106 on credit ratings. Moody's and Standard and Poor's have stated that analysts have already factored this in from earlier required disclosures and that further adjustment is unlikely.¹²

The accounting literature offers other hypotheses about motivations to adopt the mandatory FASB statement requirements early.¹³ In particular, the accounting literature emphasizes the standard's effect on financial statements as a principal motivation to adopt a mandatory standard early rather than later. This section relies on earnings management literature in two respects: First, to develop our hypothesis that management's intent in recognizing immediately the transition obligation is related to a company's financial results for the year; and, second, to specify an empirical model to explain the adoption decision of the 61 early adopters versus the 775 companies that recognized in their financial footnotes that the effect of SFAS 106 will be significant when adopted.

Of the 61 early adopters, 54 immediately recognized the transition obligation. (This transition obligation may be immediately recognized or amortized over up to 20 years.) Twenty of the companies that adopted immediately ended the year with a net loss before taking the transition obligation into account. One hypothesis, called the "big bath theory," suggests that companies with a decline in earnings may take that opportunity also to report other discretionary bad news (Healy 1985). Such a "big bath" clears the financial statement all at once, and negative items do not affect the income in future periods. Table X suggests this might be the reason some of the sample companies chose early adoption. For eight of the 18 companies that already had a net loss before recognizing their net transition liability, the transition amount was more than half of their total loss. An ad-

TABLE IX

Increase in Annual Cost

<u>Multiple of Prior Cost</u>	<u>Number of Companies</u>	<u>Percentage of Companies</u>
0 to 0.9 times	2	3.3%
1 to 1.9 times	13	21.3
2 to 2.9 times	8	13.1
3 to 3.9 times	5	8.2
4 to 4.9 times	2	3.3
5 to 5.9 times	2	3.3
9 to 9.9 times	1	1.6
Over 10 times	2	3.3
Not Available	26	42.6

TABLE X

Magnitude of Transition Write-Off for Companies With Negative Net Income

<u>Company</u>	<u>Net Loss Due to Write-Off (1.00 = 100%)</u>
Pittston Co.	0.88
Georgia Pacific Corp.	0.84
IBM	0.80
Digital Equipment	0.79
Weyerhaeuser Co.	0.77
Woolworth Corp.	0.68
Reading & Bates Corp.	0.62
Pope & Talbot Inc.	0.56
West Co. Inc.	0.43
Brush Wellman Inc.	0.37
Owens Corning Fiberglas Corp.	0.31
Homestake Mining Co.	0.22
Henley Group Inc.	0.18
American Standard, Inc.	0.17
Ecolab Inc.	0.10
Columbia Gas System Inc.	0.10
AMC Entertainment Inc.	0.07
Fibreboard Corp.	0.05

ditional two companies had a net loss as a result of the transition amount.¹⁴

The accounting literature also offers, converse to the "big bath theory," the hypothesis that healthy companies, those that are doing very well, will take the charge early to help smooth their income (McNichols and Wilson 1988). This may be the case with 34 of the 54 sample com-

TABLE XI

**Magnitude of Transition Write-Off
for Companies With Positive Net Income**

Company	Net Income Due to Write-Off (1.00 = 100%)
Peter Kiewit Sons Inc.	0.04
John H. Harland Co.	0.05
Freeport McMoran Copper & Gold	0.05
Super Valu Stores Inc.	0.06
Tootsie Roll Industries, Inc.	0.07
Abbott Labs	0.11
Fleming Cos. Inc.	0.13
Stanley Works	0.13
American President Co's	0.16
American Stores Co.	0.17
Phillips Petroleum Corp.	0.17
Tiffany & Co.	0.20
United States Shoe Corp.	0.22
Philip Morris Co. Inc.	0.23
Provident Life & Accident Ins.	0.26
Hancock Fabrics Inc.	0.27
Northrop Corp.	0.30
Communications Satellite Corp.	0.37
Washington Post Co.	0.40
General Electric Co.	0.41
Commercial Intertech Corp.	0.45
Crane Co.	0.50
Snap-On Tools Corp.	0.53
International Paper	0.54
Freeport McMoran Inc.	0.58
Bausch & Lomb, Inc.	0.68
JCPenney Co. Inc.	0.70
Pennzoil Co.	0.70
Warner Lambert Co.	0.75
Brown Group Inc.	0.76
Manville Corp.	0.83
Mead Corp.	0.89
Blount Inc.	0.90

panies. These 34 companies have positive net income for the year even after recognizing the transition amount for the postretirement benefits. Table XI shows the magnitude of the transition charge as a percentage of the net income before the transition charge for these companies. Management for companies with low percentages may have decided to take the write-off to smooth out their excellent financial performance that year. For 21 of the companies, the transition amount was less than 50% of the income in the year of adoption.

Another theory contrary to the "big bath theory" relates to company executive bonus plans. Large companies generally have an earnings-based bonus plan as part of their reward system for upper management. Fox (1980) found that this is true for 90% of Fortune 1000 companies. Managers may select accounting accruals that maximize their bonuses (Watts and Zimmerman 1978).

Watts and Zimmerman described the political costs of adopting accounting standards early. Large firms are subject to more scrutiny from regulatory forces through antitrust and tax laws and the Federal Trade Commission. However, Espahbodi et al. (1991) state political costs may be reduced for SFAS 106 adoption since income is generally reduced by implementation. Therefore, large firms would have an incentive to adopt early. Senteney and Strawser (1990) also discuss the size of adopters and propose that only large firms may be able to expend the resources necessary to adopt any accounting pronouncement prior to its mandatory implementation date. Large firms generally use consultants more and generate more internal data (Langer and Lev 1993), enabling them to produce the valuation of the retiree health plan that SFAS 106 in effect requires.

Because the data collected are all from one financial year, it is possible to test for statistical differences between the 61 early adopters and the 775 nonadopters that had nonetheless stated in footnotes the effect was significant. Various firm level variables are included in our empirical model in order to test the competing theories of motivation described above. First, to test the "big bath theory," the return on shareholder equity before changes to net income is compared to equity for APBO. For companies that were motivated to take the big bath, we hypothesize that this relationship is positive and positively affects their decision to adopt early.

Next, the standard requires firms to recognize liabilities, thus, increasing liabilities which in turn lowers equity and may violate debt covenants. Thus, managers of firms that may be concerned about the possible limitation on their ability to borrow in the future or the possible penalties for violating current contracts will not find early adoption attractive. Rather, they would require additional time to renegotiate and possibly restructure debt as well as to educate the holders of this debt. Therefore, we hypothesize that firms with low debt-to-equity ratios would tend

to adopt early, while firms with high debt to equity would adopt later. The effect of debt covenants is analyzed using a measurement proxy: the ratio of total debt to total equity (Salatka 1989; Espahbodi et al. 1991).

We also test the potential effect of bonuses on the company's decision to adopt. If earnings estimates indicated a bonus, management would not jeopardize this bonus by recognition of the large additional expense associated with APBO: These companies would not adopt early. However, management bonuses are generally subject to a ceiling and, therefore, companies with extraordinary earnings could take the deduction without decreasing bonuses. The hypothesis is that the greater the return on investment (net income/invested capital), the more likely the company would adopt SFAS 106 early. We also test the relationship between a company's already high expenses and its decision to adopt early, causing a low or negative net income ratio. High expenses are measured as a company's net income ratio (net income divided by net revenues).

The final variable studied is the effect of size, which is used as a proxy for political costs. We hypothesize that large firms will tend to adopt SFAS 106 earlier than small firms and measure size both as the company's total assets¹⁵ and as its number of employees.

EMPIRICAL RESULTS

Both LOGIT and ordinary least squares analyses were performed with assets, number of employees, return on shareholders' equity, debt-to-equity ratio, return on investment and net-income-to-net-revenue ratio as independent variables. To capture potentially nonlinear relationships, debt-to-equity ratio was entered in both simple and squared values, and assets entered in log form.

The estimation procedures produced similar results: Only debt/equity and number of employees were significant at the 0.05 level. First, the results suggest that early adopters are likely to be firms with lower debt/equity ratios than the non-adopters and that the added debt of the retiree health liability did not cause major problems with their debt covenants. Secondly, the employers with larger employee groups will adopt earlier than small employers. This is expected because the political costs for these firms is minimal since SFAS 106 only lowers net income. Large firms also have the advantage of the necessary information to appropriately time their adoptions.

CONCLUSION

The Financial Accounting Standards Board issued SFAS 106 to recognize the potentially substantial costs of employers' promises to provide health insurance to their retirees. SFAS 106 makes the accounting treatment of retiree health similar to that for pensions: The present and future costs of the benefits are to be reflected on a company's financial statements in order to give investors a true picture of the company. SFAS 106 gives employers a window of several years before the mandated implementation. During this time, firms' financial statements will vary depending on the timing of the adoption of the retiree health standard. This study provides data about companies that adopted SFAS 106 early. Retiree health benefits have generally not been funded by this group.

At least three of the findings of this study are significant. First, the effect of the APBO on the net worth of the early adopters was below the projected national average of a major study. Second, companies that adopted SFAS 106 seemed motivated by a desire to get the bad news behind them, taking the transition obligation (past service liability) as a one-time charge rather than amortizing it. By doing this immediately, expenses in future years would not be increased by the amortization of the transition expense. Third, our empirical results suggest that the timing of adoption is affected by firm-specific variables such as the number of employees and the debt-to-equity ratio. This is consistent with research on other studies of early adopters of prior accounting standards. ◀

Authors' Note: The authors wish to thank Dr. Linda Martin and Dr. Mahmoud Wahab for statistical assistance.

Endnotes

1. SFAS 81, Appendix B, November 1984.
2. SFAS 81, paragraph 27.
3. The SEC also required companies to disclose information about postretirement benefits in Staff Accounting Bulletin 74. At the Emerging Issues Task Force meeting in November 1990, it was reported the SEC requirements would be effective when FASB issued the SFAS on accounting for postretirement benefits.
4. SFAS 106, paragraph 6.
5. SFAS 106, paragraph 11.

6. The annual service is the actuarial present value of the benefits earned in the accounting period.
7. The interest cost is the increase in APBO due to passage in time at the assumed discount rate.
8. This is because the actual experience is different from assumptions, whether or not realized.
9. Both improvements and reductions in benefits are generally required to be spread over the remaining service life of each employee or the remaining life expectancy of the participants if almost all participants are fully eligible for benefits.
10. Because not all of the transition obligation and gains and losses may be currently recognized, the accrued postretirement benefit may differ from this amount.
11. A discount rate that is too high understates the APBO. The SEC may require companies to justify a discount rate that is considered too high, according to the *Mercer Report* #34, November 10, 1993.
12. See the *Wall Street Journal*, September 5, 1989, p. 4; *National Underwriter*, September 18, 1989, p. 3 and September 25, 1989, pp. 21-23; and *Pensions and Investment Age*, September 18, 1989, pp. 2, 61.
13. Most of the accounting literature deals with standards that increase recognition of income rather than effects similar to SFAS 106 that decrease reported income by shifting from a pay-as-you-go accounting method to an accrual one.
14. One other company chose immediate recognition, but was in fresh start (bankruptcy actions) and therefore is not shown in this table.
15. Langer and Lev (1993) used a somewhat similar test.

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