



## MEMORANDUM

October 12, 2011

**To:** House Oversight and Government Reform Committee  
Attention: Jeffrey Post

**From:** Janemarie Mulvey, Specialist in Health Care Financing, x7-6928

**Subject:** **USPS Funding and Accounting Issues for Retiree Health Benefits**

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On December 20, 2006, the Postal Accountability and Enhancement Act (PAEA, P.L. 109-435) was enacted into law and was the first broad revision of the 1970 statute that replaced the U.S. Post Office with the U.S. Postal Service (USPS), a self-supporting, independent agency of the Executive Branch.<sup>1</sup> Among other things, PAEA required the USPS to pre-fund their future retiree health benefits (provided through the Federal Employees Health Benefits Program) by establishing the Postal Service Retiree Health Benefits Fund (PSRHBF). The law established set payments to the fund from 2007 to 2016 of between \$5.4 billion to \$5.7 billion annually.

As the USPS faces increased financial challenges, Congress has temporarily reduced the USPS current retiree health payments to the PSRHBF.<sup>2</sup> On October 1, 2009, the Legislative Branch Appropriations Act [of] 2010 (P.L. 111-168) was signed into law and provided immediate relief by reducing the USPS payment in 2009 to the PSRHBF from the required \$5.5 billion to \$1.4 billion. More recently, in September 2011, Congress delayed the USPS FY2011 RHBF payment date from September 30, 2011 to November 18, 2011 (P.L.112-36).

The Office of Inspector General (OIG) of the USPS has stated in a recent report that the Office of Personnel Management's (OPM) recent estimates of their future retiree health liabilities are too high and that under the current payment schedule mandated by PAEA, the USPS will have overfunded its retiree health liability in 2016.<sup>3</sup> In response to these concerns, the Postal Regulatory Commission (PRC) has undertaken an analysis of the different approaches employed by the USPS/OIG and the OPM to calculate the present value of the Postal Service's obligations related to the PSRHBF.<sup>4</sup> The PRC noted in its report

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<sup>1</sup> See CRS Report R40983, *The Postal Accountability and Enhancement Act: Overview and Issues for Congress*, by Kevin R. Kosar.

<sup>2</sup> For more information on the USPS financial situation see CRS Report R41024, *The U.S. Postal Service's Financial Condition: Overview and Issues for Congress*, by Kevin R. Kosar.

<sup>3</sup> Office of Inspector General, Final Management Advisory Report – Estimates of Postal Service Liability for Retiree Health Care Benefits (Report Number ESS-MA-09-001), as revised July 22, 2009.

<sup>4</sup> Postal Regulatory Commission, *Postal Regulatory Review of Retiree Health Benefit Fund Liability as Calculated by Office of Personnel Management and the U.S. Postal Service Office of Inspector General*, July 30, 2009.

to Congress that the discrepancy between the two valuations arises because each was developed for different reasons and both are reasonable. Specifically, the PRC report states:<sup>5</sup>

“The OPM estimate serves to meet an *annual financial reporting requirement*. In contrast, the USPS/OIG estimate is designed to estimate the *funded status* of the RHBF as of 2016. The estimates differ by \$57 billion in terms of full liability, and support different actuarial payment schedules.”

This memorandum briefly discusses the differences between funding and accounting for retiree health benefits in the private sector and for USPS specifically. Information provided in this memorandum will be used for other CRS products.

## Private Sector: Accounting and Funding Requirements

Before discussing the accounting and funding requirements for USPS, it is helpful to understand how firms in the private sector account for and fund their retiree health liabilities.<sup>6</sup>

When a firm promises future benefits such as retiree health or defined benefit pension plans it incurs a liability for those future benefits. Prior to the 1990s, most firms recognized these liabilities on a pay-as-you-go basis on their financial statements, meaning the liability does not occur until an employee retires and begins to receive the benefits. As the population ages, there has been increased emphasis in both the public and private sectors to recognize the cost of retirement benefits (including retiree health) sooner, and in some cases to pre-fund these benefits. In the last few decades, there have been two key accounting rules introduced in the private sector that require private firms to account for these retiree health benefits as current liabilities (i.e., accounted for over active employee’s working careers) instead of when they are actually paid in the future.

In the private sector, the regulation of accounting assumptions and requirements relating to retiree health benefits are issued by the Financial Accounting Standards Board (FASB) and are based on generally accepted accounting principles (GAAP). FASB’s Financial Accounting Standard No. 106 (FAS 106) became effective for most (single-employer) private sector employers in 1993, and required firms to report the present value of their future retiree health liabilities as a footnote on their balance sheets. For many large corporations, these liabilities were quite large, in millions and in some cases billions of dollars.<sup>7</sup> In addition, in 2006, FASB issued new requirements in Statement No. 158 for firms to report the funding status of all post retirement plans on their balance sheet.

While FAS 106 and 158 did not require companies to prefund these future benefits in a separate fund, the inclusion of these liabilities and their funding status on a firm’s financial statement directly affected their market valuation and stock prices. Some companies responded by taking a one-time charge against earnings, while others amortized the cost over many years.<sup>8</sup> Over time, many large firms who previously offered retiree health benefits reduced their retiree health liabilities through reduced benefits, increased cost sharing or elimination of these plans altogether. According to various surveys, in 2010, about 28% of

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<sup>5</sup> Ibid.

<sup>6</sup> A set of accounting rules (Statement 43 and 45) have been issued by the Government Accounting Standards Board (GASB) to apply to state and local governments which are similar to requirements for single-employer plans in the private sector.

<sup>7</sup> R. McDevitt, J. Mulvey and S. Schieber, *Retiree Health Benefits: A Time to Resuscitate*, Watson Wyatt Worldwide, 2002.

<sup>8</sup> Employee Benefit Research Institute, *Fundamentals of Employee Benefit Programs*, Washington, D.C. 2005.

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large firms (with more than 200 workers) offered a retiree health plan to active workers; this compares to 66% of survey respondents who offered retiree health coverage in 1988.<sup>9</sup>

Accounting for retiree health liabilities on a firm's financial statements is entirely apart from any financial or budgetary arrangement to fund that obligation. While funding of retiree health benefits is not mandatory in the private sector, about 25% of firms do fund their retiree health obligations (largely through a Voluntary Employees Beneficiary Association, VEBA agreement). Unlike the accounting rules, the regulations on minimum funding assumptions for retiree health and pension benefits for private firms are issued by the Internal Revenue Service.<sup>10</sup> The rationale for the IRS regulations on funding mechanisms is because there are some limited tax preferences afforded to these funding arrangements.

## The USPS: Key Difference Between Funding and Accounting Rules

The applicability of the FAS 106 financial accounting requirements for disclosing retiree health benefit liabilities has been reviewed by the Government Accountability Office (GAO) on a number of occasions. In its initial review, GAO did not believe the FAS 106 requirements should apply to the USPS.<sup>11</sup> Later, however, GAO reconsidered this decision and stated that USPS is a unique entity unlike other firms under FAS 106. It is an independent establishment in the executive branch of the U.S. government.<sup>12</sup> GAO concluded that the USPS should consider whether the accrual basis of accounting (similar to FAS 106) is both the acceptable and appropriate method of accounting for their post retirement health benefits.

As for funding future retiree health benefits, both the Congressional Budget Office (CBO) and GAO have repeatedly raised the point that the federal government will be liable for USPS retiree benefits if the USPS faces financial difficulties in the future and is unable to pay those costs itself.<sup>13</sup> As noted earlier, the requirement to prefund these benefits in a separate account was enacted under PAEA, which required the Postal Service to pre-fund its retiree health benefits for current and former workers. The following discusses two key assumptions regarding the interest rate and the workforce that differ in accounting versus funding requirements for the USPS.

### Interest Rates

Interest rate assumptions differ from an accounting versus a funding approach. For funding purposes an interest rate (often called the valuation interest rate) is used to discount future benefits to determine plan liabilities in current dollars. For funding purposes, this interest rate should be a reasonable expectation of the long-term future rate of return on assets. For accounting purposes, the discount rate reflects market rates currently applicable for settling the benefit obligation or rates of return on high quality fixed income securities at the time of the measurement date. Both the USPS/OIG and the OPM estimates use the same interest rate of 6.25% for funding and accounting estimates. However, Mercer (in their comments to the

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<sup>9</sup> Kaiser/HRET Survey of Employer-Sponsored Retiree Benefits, 1999-2010; The Health Insurance of America (HIAA) survey data in 1988.

<sup>10</sup> IRC Section 419 and 419A.

<sup>11</sup> Government Accountability Office (GAO), *Financial Reporting: Accounting for the Postal Services' Postretirement Health Care Costs*, GAO/AFMD-92-32 (Washington, D.C.: May 20, 1992).

<sup>12</sup> See Letter from David Walker, Comptroller General, Government Accountability Office, "U.S. Postal Service: Accounting for Postretirement Benefits," GAO-02-916-R, September 12, 2002.

<sup>13</sup> See Letter from Barry B. Anderson, Acting Director, CBO, to the Honorable Jim Nussle, Chairman, Committee on the Budget, U.S. House of Representatives (Jan. 27, 2003), and GAO, U.S. Postal Service: Strategies and Operation to Facilitate Process Toward Financial Viability, GAO-10-455.

PRC) recommends a lower interest rate for funding purposes which would, in turn, increase the expected liability of the program and also increase the amount that would be pre-funded.<sup>14</sup>

## Demographic Assumptions About the Workforce

For funding purposes, a *static* or closed group valuation takes into account only the accrued or prospective benefits of a person currently affiliated with the plan as an active participant, a terminated vested participant, or a retired participant or beneficiary. This type of valuation is required under federal law for pensions for validating tax deductions and establishing minimum funding levels.

Some plan sponsors in the private sector can employ a *dynamic* valuation, which takes into account the accrued and prospective benefits of not only the current group of participants but also those who may enter the plan during some finite future period (and that could be part of a future generation of workers). The dynamic valuation is primarily designed to inform an employer about the future costs, and cash flow of its retiree health plans and is generally used for accounting purposes.

In the case of the USPS, the distinction between funding and accounting assumptions is important to whether current funding requirements use a static or dynamic valuation. Under current law, PAEA (P.L. 109-435) requires USPS to determine the actuarial present value of future retiree health payments for *current or former employees* and to amortize that liability over a 40 year period. The USPS/OIG funding estimate actually goes a step further and included assumptions for budgeted reductions in the workforce in 2007 and projected this forward in determining its funding liability for future retiree health liabilities.

For accounting purposes, OPM could include on its financial statement some projection of future benefits for those who may enter the plan at a future date if there was a legitimate reason to expect the USPS workforce to grow over time. However, in its recent accounting statement for USPS, OPM assumed that the USPS workforce would not grow over time and instead based their projections of the future workforce on a snapshot of the current year in terms of number of employees, holding this level of employment constant into the future.

## Future Estimates

Beginning in 2017 (and each year thereafter), OPM shall compute on an annual basis the net present value of future retiree health liabilities relative to the current fund balance and determine a schedule of annual installments to provide for the liquidation of any liability or surplus by September 30, 2056. Upon request by the USPS, the PRC can review the OPM estimates and employ the services of an actuarial firm to review the OPM assumptions and report their findings to USPS, OPM and Congress.

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<sup>14</sup> Mercer Consulting, *Review of OPM and OIG Retiree Medical Valuation Reports for Postal Regulatory Commission*, July 20, 2009.