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Retiree-Medical Plans Are Transformed Into Source of Profits by Sears, Others

By ELLEN E. SCHULTZ
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[Sears Roebuck](#) & Co. has figured out how to turn its medical-benefits program for retirees into a source of corporate income.

You read that correctly. Last year, the giant retailer's retiree-medical plan added \$46 million to the Sears bottom line. And that was on top of the \$38 million the benefits program contributed in 1998.

The key to these surprising profits is an arcane accounting rule introduced in the early 1990s. The rule required companies for the first time to report their total anticipated costs for retiree-health coverage. Many companies used the rule to justify cutting that coverage, or shifting its cost to retirees. As a result, a lot of older Americans are struggling to pay their medical bills.

The rule also offered companies a way to arrange their financial statements so that retiree-benefit programs actually became new profit centers.

Employers and benefits consultants have received heat recently for turning pension plans into sources of corporate income. Now, the transformation of retiree-medical programs into opportunities to bolster earnings demonstrates that these companies and their outside advisers possess multiple subtle methods to squeeze profits from their current and former employees.

 Using Trust Funds to Pay Retiree Benefits Can Help the Bottom Line

This latest corporate maneuver was made possible by Financial Accounting Standard 106. Accounting authorities required that large companies adopt the rule by 1993. At a time when medical-cost inflation was running in double digits, the rule was

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supposed to force companies to acknowledge the potentially huge retiree-medical liability many of them seemed to face.

Some of the charges that companies initially reported on their income statements under the new rule were indeed gargantuan, and they fueled an atmosphere of crisis surrounding corporate health-care costs. Many companies invoked the mammoth liabilities to explain why they had to reduce retiree benefits.

But the crisis turned out to be exaggerated. An analysis of corporate filings with the Securities and Exchange Commission reveal that over the 1990s, companies faced lower medical-cost inflation rates than they had predicted when standard 106 took effect and, as a result, smaller retiree-health liability.

What's more, many companies actually had incentives to err on the side of taking overly large initial charges under the new rule. One incentive was that excessively pessimistic estimates of future health-care liability provided a rationalization for reducing retiree benefits. That spelled bad news for millions of retirees, such as Elaine Russell, a 77-year-old former Sears worker in Seattle, whose rising medical premiums have forced her to rely on a free food bank. Retired Unisys Corp. accountant Albert Shaklee, 70, was forced to go back to work at a minimum-wage factory job for a time to keep up with his increased premiums.




Elaine Russell

Companies had a second incentive to take inordinately huge retiree-benefit charges: If the estimates proved too big -- which is, in fact, what happened in many cases -- companies knew they could adjust their retiree liability downward by recognizing a series of paper gains on their income statements. This pool of potential gains could be drawn upon over a period of years and used to offset retiree-medical expenses.

The New Math

The kicker is that at numerous companies, including Sears, the paper gains not only erased the retiree-benefit expenses, but exceeded them. And that is how benefit plans came to boost the bottom line.

This sort of income isn't like cash that can be spent. But it can be used to buff a company's financial image by smoothing over dips in operating income. "It can sand the rough edges in a bad quarter," says Jack Ciesielski, an independent accounting expert who publishes The Analyst's Accounting Observer, a newsletter.

 Taking a Scalpel to Retiree-Medical Benefits

Liability Policy

Consider the case of Sears. In response to accounting standard 106, the retailer took a whopping one-time charge of \$2.9 billion in 1992 to reflect the present value of its entire obligation to pay for retirees' health care. Wall Street analysts didn't fret much about this accounting estimate because it had no immediate effect on operating cash flow. The analysts also knew that unlike vested pensions, which under federal law, companies must pay out, health coverage generally may be curtailed, either by killing benefits outright or making beneficiaries pay some or all of the bill.

Sears used the charge as justification to increase substantially the amounts that retirees would have to pay for health coverage. Shifting the financial burden to retirees has been the only way for Sears, based in Hoffman Estates, Ill., to "remain competitive with the retail industry, as far as costs go," company spokeswoman Peggy Palter says.

Over the course of the 1990s, however, the rate of inflation of medical costs levelled off and decreased, making the initial Sears charge vastly overblown. In addition, the company's shifting of costs to retirees reduced its own obligation. To illustrate: In 1992, Sears reported an annual expense of \$301 million for retiree-health benefits. The comparable figure for 1996 was just \$76 million, a 75% drop.

To reflect its own earlier overestimate of its liability, Sears posted credits in its financial statements in the mid- and late-1990s. The combined effect of these accounting adjustments and the retailer's continued benefit cuts was that by 1997, the Sears retiree-benefit plan was adding \$41 million to overall net income. Ms. Palter of Sears confirms this account.

Other companies that have boosted their bottom lines by this method include [R.R. Donnelley & Sons Co.](#), [Sunbeam Corp.](#), [Tektronix Inc.](#), and [Walt Disney Co.](#), according to the analysis of corporate filings with the SEC.

Meanwhile, retirees like Ms. Russell of Seattle are paying the price. She stopped working for Sears in 1984, after nearly four decades of full-time clerical duties at the retailer. When she turned 65, the federal Medicare program began reimbursing her for routine doctor and hospital bills. Her Sears retiree coverage provided supplemental reimbursement for prescription drugs.

In 1998, when her prescription costs were about \$50 a month, the premium for her supplemental coverage doubled to \$58. That might not sound like a lot, but proportionally,

How It Worked at One Company:

Walt Disney

Step #1: Following its 1993 change in accounting standards, the company took a \$202 million pre-tax charge to reflect retiree-health liability.

Step #2: Citing the accounting change and large liability, Disney slashed retiree health

it was a huge bite out of her monthly Sears pension of \$183.

The premium increase prompted Ms. Russell to drop out of the Sears plan in 1998. That gamble has hurt, because today she needs additional medications for colitis and a thyroid condition. Her monthly prescription bill has leapt to \$180.

"I've always saved," says Ms. Russell, a widow who collects \$974 a month in Social Security. She drives a 1977 Datsun station wagon and makes her own clothes. Still, it wasn't until Sears doubled the cost of her benefits in 1998, she says with evident embarrassment, that she started taking advantage of a Seattle senior center's free food bank for herself and her two cats. One day recently, she picks out hot dogs donated by a local grocer because they are close to their expiration date. She also chooses overripe bananas, which she says aren't bad if cooked.

Sears maintains that even after shifting costs to retirees, it is "far more generous with benefits than others in our industry," says Elisabeth Rossman, vice president for benefits. "We have taken measures to prudently reduce our costs," she adds. "We were trying to strike a balance between duty to shareholders, so they could get an adequate return on investments, with our duty to retirees."

Coming Soon: More Cuts

Next Jan. 1, the company plans to cease paying anything for health coverage for employees over 65 who retire after that date, Ms. Rossman says. However, in 1998, she points out, Sears doubled, to 20%, the discount retirees may receive on clothing purchases.

Companies such as Sears stand to gain when retirees like Ms. Russell drop out of the medical plan, because that ends a company's obligation to pay anything for coverage. Of the roughly 120,000 Sears retirees today, only about 80,000 are receiving medical coverage. Ms. Palter, the company spokeswoman, says costs may be one reason people drop the coverage, but that some retirees do so because they receive benefits under a spouse's plan or they return to work.

Bill Rodino, a 72-year-old retired Sears appliance repairman and supervisor in Brooklyn, N.Y., got a new job to help pay for his Sears coverage. He now works 10 to 15 hours a week as a receptionist at a

disaster retiree-health benefits, reducing its expenses by more than half the next year.

Step #3: But then, estimates of benefit liability turned out to be excessive, so the company began to report paper gains to reflect lower-than-anticipated expenses. In 1995, Disney's gain was \$43 million. The company reported a total of \$47 million more in gains from 1996 through 1998. Thus, its retiree-health plan boosted its bottom line.*

**Disney confirms the figures but declines further comment.*

funeral home. That provides the extra cash to afford last year's 600% jump in his Sears premium, which is now roughly \$80 a month. His prescription co-payments have risen to \$75 a month.

Even with his part-time job, he and his wife, Jeanne, have gradually drawn down their savings for day-to-day expenses. They weren't aware of the improved Sears clothing discount, says Mrs. Rodino, because they haven't bought new clothes in years.

Seeds of a Windfall

The seeds of the retiree-health windfall for many companies were planted in the late 1980s, when the Financial Accounting Standards Board, the accounting industry's rule-making body, began to develop standards for reporting retiree-health obligations. Major companies, such as [General Electric](#) Co. and [International Business Machines](#) Corp., played an active role in the process, suggesting ideas to the accounting board. Companies showed the board computer simulations of how various proposals would affect corporate bottom lines.

Corporations would have preferred not to have to report retiree-medical liability at all. But once that became inevitable, big companies urged the board to give them flexibility in how they projected their retiree-benefit costs, according to people involved in the process. The accounting board went along with many of their suggestions when it issued standard 106.

Jeffrey Petertil, an independent actuary who was an adviser to the accounting-board task force that drafted the new rule, warned in 1992 that standard 106 was so flexible that it would permit companies to overstate or understate their liabilities. But when he expressed this dissenting view in a newspaper opinion piece, his largest client, a major accounting firm, fired him the next day, Mr. Petertil says. He declines to name the firm.

Smoothing the Dips

One illustration of the flexibility is the great leeway standard 106 allowed companies to adjust the medical-cost inflation rate used to estimate retiree liability. Having pegged that rate very high early in the decade, companies were able in later years to report income-statement credits that could be used to smooth earnings dips, says Mr. Ciesielski, the independent accounting expert.

Sears, for example, initially used a 14% medical-inflation rate to estimate its liability in 1992, which was in line with national trends. By 1997, Sears had lowered its estimate to 11%. In 1998, it slashed the rate again to 6%.

The proportionally huge rate reduction in 1998, along with less generous benefits, permitted the retailer to report credits that allowed its retiree-

health plan to contribute income to the company's bottom line. In 1998, the \$38 million credit was the equivalent of a 2% increase in operating income.

The rate changes were made at a time when the company was struggling with credit-card delinquencies and weak apparel sales. Mr. Ciesielski says it's fair to assume that Sears and other companies have used credits from these plans "to smooth earnings during rough times."

Ms. Palter, the Sears spokeswoman, confirms the medical-inflation figures but stresses that the company didn't act to smooth its earnings. Sears changed the inflation assumptions "to be consistent with industry trends," she says. "It was a fiduciary duty to be as accurate as we could. Our experience was already showing that our estimates were too high, and the expenses would be lower."

Donnelley was another company that used standard 106 to justify benefit cuts and improve its earnings numbers. The company said in a letter to retirees in October 1992 that the new accounting rule would have "a serious negative impact on our earnings." The letter noted that because of "skyrocketing" health-care costs, the Chicago-based printing company was forced to begin charging retirees for their once-free medical benefits. Otherwise, Donnelley warned, it would fail to remain "competitive."

Thanks to the new fees, the company slashed its annual retiree-medical expense by more than half in 1995. By the next year, Donnelley's retiree-benefits plan was adding income to the company's bottom line. (Donnelley and some other companies also saw their benefits expenses fall, thanks to investment returns in trust funds set up to finance retiree-health benefits.)

A Donnelley spokesman confirms this account but stresses that the company had reserved the right to change retiree benefits.

Richard Mebane retired from Donnelley in 1993, at 60, when the Chicago plant where he worked closed. He qualified for a \$277 monthly pension, on top of his Social Security check of \$936. With expensive prescriptions for high blood pressure, cholesterol and a bladder problem, he felt the squeeze when Donnelley in 1996 imposed a \$250 annual deductible, which since has doubled to \$500, for health coverage that supplements Medicare. He also pays an \$18-a-month premium.

"Most of the time, I take the medicine every other day, to keep the cost down," says Mr. Mebane, now 67. Even with the company coverage, he's responsible for a 30% co-payment for prescriptions. By cutting his dosage, he saves about \$40 a month, he says. "If I start to feel light headed, I take it every day until I feel better."

Three years ago, Mr. Mebane took a part-time janitor's job at St. Elizabeth's preschool on Chicago's Southside, where he polishes floors and

swabs out toilets. He receives no medical benefits from the minimum-wage post.

Another company that wasted little time between adopting standard 106 and slashing retiree-health benefits was McDonnell Douglas Corp. In January 1992, the aeronautical giant reported a \$1.5 billion after-tax retirement-benefits charge. In October 1992, it announced that over four years, it would phase out all health-care coverage for its 20,000 nonunion retirees.

In an Oct. 7, 1992, letter to retirees, John McDonnell, then the company's chief executive, said: "The problem we have been wrestling with is not 'just' that health-care costs continue to skyrocket, as everybody knows." In addition, he wrote, standard 106 "threatened to deal a heavy blow to our bottom line."

In fact, by ending retiree benefits, McDonnell Douglas generated \$698 million in pretax income reported in 1992. A separate benefits reduction affecting a group of retired unionized engineers generated another gain, this one a more-modest \$70 million, reported in 1993. A spokesman for Seattle-based Boeing Corp., which has acquired McDonnell Douglas, confirms the numbers and the letter's authenticity but declines any further comment.

McDonnell Douglas retiree Robert Taylor couldn't believe the news about the benefits cut in 1992. He was especially outraged that the company's pension plan was lavishly overfunded, but McDonnell Douglas wouldn't use that surplus to pay for retiree-medical benefits, as companies are legally allowed to do.



Rhada Taylor

Mr. Taylor, who had joined McDonnell Douglas shortly after World War II and retired as supervisor of technical publications in 1979, died at the age of 79, just before the cut took effect. His wife, Rhada Taylor, now 87, chose to have the new \$168 monthly premium for coverage supplementing Medicare deducted from her widow's pension of \$420 a month. But the premiums have increased every year. By 1999, her pension money had shrunk by roughly 60%. After another premium increase scheduled to take effect Jan. 1, her monthly pension will be only \$79.

McDonnell Douglas's health-care reductions have "wiped me out," says Ms. Taylor, who receives a monthly Social Security check of \$1,009. She says she has cut back on wedding and graduation gifts.

As McDonnell Douglas was dispensing bad news to its retirees in October

1992, Unisys was doing the same.

That month, the Blue Bell, Pa., computer company dispatched a letter to 25,000 former employees, saying that "increasing medical costs and growing world-wide competition" were forcing it to "replace" their coverage. The new plan, Unisys said, "will be cost-effective, will provide financial protection against the high cost of illness or injury, and will continue to be available at group rates."

The bad news was that the company, which had paid for past coverage, would now shift the entire cost to retirees over a four-year period.

The missive angered the retired Unisys accountant, Mr. Shaklee, then 61. When deciding in 1989 to retire early, he says he had relied on the company's written promises that he and his wife would have medical coverage for life. Such promises of lifetime coverage were common in the downsizing waves of the late 1980s and 1990s.

Despite his irritation, Mr. Shaklee bought the coverage at first, because his wife Doris, then in her late 50s, had been diagnosed with breast cancer. The Lake Kiowa, Texas, couple couldn't have bought insurance for Doris elsewhere because of her illness, and she hadn't yet hit the Medicare-eligibility age of 65. By 1996, the couple's monthly premium had jumped to \$784, exceeding Mr. Shaklee's pension of \$727.

So, Mr. Shaklee dropped the Unisys coverage and sought a job that would offer more-affordable insurance. Retiree health-care coverage typically costs more than group plans that include younger, healthier people.

At the Gainesville, Texas, parts-grinding factory where he applied for a midnight-shift job "they kept looking at my resume, asking me whether I knew it was minimum wage," he recalls. He had earned \$70,000 a year at Unisys. Hesitant to state the real reason he wanted the job -- the \$110-a-month health insurance -- Mr. Shaklee told his interviewers he wanted to work with his hands.

He held the factory job, and got the insurance, for two years, quitting when his wife got closer to qualifying for Medicare. But today they are scrimping. Prescription drugs cost the Shaklees about \$220 a month. To save money, they scratched visits to their grandchildren in California for three years. "If we have a medical catastrophe, we'll be in trouble," says Mr. Shaklee. He is one of a group of Unisys retirees who have sued the company in U.S. district court in Philadelphia, seeking restoration of their benefits.

A Unisys spokesman declines any comment on retiree benefits, citing the pending lawsuit. The company has maintained in the court case that it had

reserved its right to terminate the disputed benefits.

Beyond standard 106, another accounting-rule change that became effective in 1992 also has helped employers. Financial Accounting Standard 109 allowed companies to take credit immediately for certain tax deductions expected in the future. The deductions in question are those associated with liabilities such as retiree-medical benefits. Companies could use standard 109 to reduce -- or even cancel out -- their initial charges for retiree-health liability.

Unisys, for instance, took a charge in 1992 of \$195 million for retiree-medical benefits. But under Standard 109, the company was permitted to show a \$425 million credit on its 1992 income statement for anticipated tax deductions associated with all manner of liabilities. The result was that in 1992, Unisys reported a net one-time gain of \$230 million, courtesy of the changes in accounting standards.

Utilities Forced to Pay Refunds

The one industry where at least some employers have faced public criticism for their retiree-health accounting is the utility field. Certain state regulators have been willing to act in this area by using their authority to require consumer refunds.

Warning of escalating retiree-health benefits in 1993, Pacific Gas & Electric Corp. sought additional funds to pay the costs. The California Public Utilities Commission said PG&E could raise rates \$181 million that year. Simultaneously, PG&E adopted plan changes that limited the amount it would actually contribute to retiree benefits. The company also used layoffs and attrition to cut its payroll by 17% from 1993 through 1995, further reducing its retiree-benefit burden. PG&E's annual retirement-benefits expense stood at only \$12 million last year, down 90% from 1993.

In 1998, the California utilities commission said the company shouldn't have been rewarded for overestimating its retiree-health costs. The commission required the utility to credit a total of \$191 million to ratepayers for the years 1993 through 1995. PG&E didn't restore any benefits to retirees.

Chris Johns, a vice president and controller at PG&E, says the company didn't deliberately overestimate its benefit costs. Instead, the costs fell because of strong investment gains by the company's retiree trust fund, he adds. The refunds were made as a part of the routine regulatory process, he says.

For retirees across the country, health coverage soon could get even more scarce and expensive. Companies are running out of the paper gains they

can take because of their early-1990s overestimates of retiree-health liability. And health-care inflation is creeping up again.

In marketing material sent to current and potential corporate clients, the benefits-consulting firm Towers Perrin says employers need to think about "new strategies and approaches to managing health benefits." Among those strategies: new benefits cuts.

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Taking a Scalpel to Retiree-Medical Benefits

A combination of benefit cuts and resourceful accounting have allowed some companies to report that their retiree-benefit programs are boosting the bottom line.

Tallying the Cuts

The figures in the left-hand column are the expense amounts a company reported in the first year of operating under the new accounting standard for retiree-health benefits. In some cases that was 1992, in others 1993. Figures in parentheses reflect income-statement gains.

Company	1992/1993 (in millions)	1999	% DECLINE
Anheuser-Busch	75	16	79%
Black & Decker	21	(0.5)	100
Campbell Soup	46	14	70
Eastman Kodak	255	15	94
Walt Disney	30	10	66
R.R. Donnelley	20	(4)	100
Dow Chemical	165	50	70
Gannett	18	10	44
GTE	386	106	73
Hartford Financial	28	(3)	100
Hewlett Packard	32	0	100
Merck	90	6	93
J.P. Morgan	26	(16)	100
Norfolk Southern	35	8	77
Pacific Gas & Electric	124	12	90

Procter & Gamble	3	(336)	100
Sears Roebuck	301	(46)	100
Sunbeam	4	(0.5)	100
Tektronix	6	(2)	100
Unisys	25	6	76

Note: At some companies, retiree-health benefits include life-insurance benefits. Returns from retiree-trust funds contributed to falling expenses at some companies.

Source: Company filings

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