



December 23, 2010

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VICE PRESIDENT, CONTROLLER

SUBJECT: Management Advisory – Workers’ Compensation Liability Estimate  
(Report Number FT-MA-11-002)

This report presents the results of our review of the U.S. Postal Service workers’ compensation liability estimate, including the model used to estimate the liability (Project Number 10BM003FT001). Our objectives were to improve the workers’ compensation model and reduce the volatility of management’s worker’s compensation liability estimate. This report responds to a request from the Postal Service Board of Governors (Board) Audit and Finance Committee to examine the Postal Service’s workers’ compensation liability. This audit addresses financial risk. We will continue audit work in this area to evaluate the Postal Service’s participation in the U.S Department of Labor (DOL) workers’ compensation program and the costs and benefits of that participation. See [Appendix A](#) for additional information about this audit.

Compensation for work-related injuries of Postal Service employees falls under the *Federal Employees’ Compensation Act (FECA)*.<sup>1</sup> The Office of Workers’ Compensation Program (OWCP) within the DOL administers FECA on behalf of the Postal Service. The Postal Service is required by generally accepted accounting principles (GAAP) to account for future workers’ compensation costs not yet paid. These costs include employees’ medical expenses, payments for continuation of wages, and DOL administrative fees. The Postal Service, using an actuarial<sup>2</sup> model, estimates the workers’ compensation liability for all future payments they will make to injured employees.

In fiscal year (FY) 2009, management changed the frequency of updates made to the discount rates. Prior to Quarter (Q) 3, FY 2009, management had not updated the discount rates used in the workers’ compensation model since FY 2007.<sup>3</sup> The liability changes prior to Q3, FY 2009 were fairly stable; however, in Q3, FY 2009 management elected to update the discount rates each quarter and volatility in the resulting liability increased. Long-term liability amounts, which had increased by only \$200 million in all

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<sup>1</sup> 5 U.S.C., Chapter 81.

<sup>2</sup> Actuarial science applies the mathematics of probability and statistics to define, analyze, and solve the financial implications of uncertain future events. Actuarial science is applied in the study of financial organizations to analyze their liabilities and improve financial decision making.

<sup>3</sup> The established procedure was to formally update these rates every 3 years, with an informal review annually.

of FY 2008, increased by \$1.7 billion in Q3, FY 2009 alone,<sup>4</sup> and another \$400 million in Q4, FY 2009. The long-term liability amounts again fluctuated significantly in FY 2010 when compared with FY 2009, with changes ranging from a decrease of \$900 million in Q1, to an increase of \$2 billion in Q3. The total change in liability in FY 2010 was an increase of \$2.5 billion.

The Postal Service workers' compensation liability of \$12.6 billion at September 30, 2010, is significantly larger than that of comparable private sector companies. For example, Wal-Mart reported total self-insured liability<sup>5</sup> of \$3.2 billion on January 31, 2010; United Parcel Service reported \$ 2.5 billion on December 31, 2009; and FedEx reported \$1.6 billion on May 31, 2010. The length of time a claim remains open can affect the cost of the claim. The Postal Service has claims dating back to the era of the Post Office Department since it does not have the authority to settle claims, as private sector companies do.

## **Conclusion**

Volatility is inherent in the workers' compensation liability, not only in the Postal Service but also in other benchmarked organizations. The majority of benchmarking partners' annual reports recognized the potentially high level of uncertainty associated with estimating the financial liability for workers' compensation.

However, the Postal Service could take action to smooth or reduce the volatility of this significant liability. Specifically, management should:

- Consider using discount rates similar to the DOL.
- Revise the weights of the actuarial methods they use in the model.

In addition, management could improve the model by ensuring that personnel who develop the liability estimate better understand the model, including the assumptions made, the analyses conducted, and the rationale for the methods used. Although we did not find opportunities for economic impact in this audit, the U.S. Postal Service Office of Inspector General (OIG) will perform additional work that will address potential cost savings.

## **Discount Rates**

Effective in Q3, FY 2010, management elected to refine their estimate by developing new discount rates for compensation and medical expense that, in fact, increased the volatility of that estimate. Formerly, management developed discount rates using a simple average of a mix of projected interest rates for selected U.S. Department of

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<sup>4</sup> In 2009, management moved the annual DOL payment, historically made on September 15, to October 15; therefore, this amount also includes a liability for chargeback year 2009 of \$1.1 billion. Had the payment been made on September 15, the increase would have been \$1 billion instead of \$2 billion.

<sup>5</sup> This includes workers' compensation, general liability, auto liability, and employee health benefits.

Treasury (Treasury) securities. Starting with Q3, FY 2010, management began using a weighted average<sup>6</sup> of Treasury spot rates.<sup>7</sup> This weighted average was significantly lower than the simple average of projected rates used in the prior quarter. Management informed us they did a study to identify the best approach for developing discount rates and selected spot rates. Based on research and analysis conducted in Q3, FY 2010, management determined that the projected Treasury rates were no longer representative of the estimated fair value of the workers' compensation liability. Comparing Q3, FY 2010 to Q2, FY 2010 shows that workers' compensation liability increased by \$2.0 billion to \$11.6 billion, resulting primarily from the decrease in the discount rates.

The DOL<sup>8</sup> does not use Treasury spot rates. Instead, it discounts these projected annual benefit payments using a simple average of forecasted 10-year Treasury note interest rates from the Office of Management and Budget (OMB). The workers' compensation liability the DOL calculated was fairly consistent from FYs 2008 to 2009.<sup>9</sup> Although the Postal Service follows the Financial Accounting Standard Board's (FASB) accounting standards<sup>10</sup> and the DOL follows Federal Accounting Standards Advisory Board's (FASAB) financial accounting standards,<sup>11</sup> both sets of standards are similar in how they determine the discount rate to use. The Postal Service used spot rates because they believed this approach better measured the liability while conforming to FASB standards.

The Board's independent public accounting firm (IPA) — contracted to express an opinion on the Postal Service's financial statements — stated the use of spot rates is consistent with other companies registered with the Securities and Exchange Commission (SEC).<sup>12</sup> They pointed to guidance provided in SEC Staff Accounting Bulletin 92 (SAB 92) on discounting of environmental liabilities that, in their experience, the SEC has suggested be applied in most situations involving the discounting of recorded liabilities. They also expressed their position, consistent with SAB 92, that the discount factor applied should reflect the risk-free interest rates applicable to obligations of similar duration as the cash flows of the obligation subject to discounting for accounting purposes. We reviewed publicly available documentation to determine the existence of more specific SEC requirements for computing discount rates but were unable to find anything authoritative. Therefore, we contacted an associate chief accountant at the SEC who stated there is nothing authoritative regarding the methodology for computing discount rates. There does not appear to be any direct

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<sup>6</sup> The applicable spot rate is weighted based on claims for a given year.

<sup>7</sup> The spot rate is the price quoted for immediate settlement on a commodity, a security, or a currency.

<sup>8</sup> We benchmarked with the DOL, who determines both civilian and military agencies' liabilities for future workers' compensation benefits for civilian federal employees.

<sup>9</sup> The Postal Service liability, as computed by the DOL, on September 20, 2008, was \$9.544 billion; and on September 30, 2009, was \$9.507 billion, a decrease of \$37 million, or 0.4 percent.

<sup>10</sup> GAAP applicable to public companies.

<sup>11</sup> GAAP applicable to federal agencies that adhere to the *Chief Financial Officers Act of 1990*.

<sup>12</sup> The Postal Act of 2006 requires the Postal Service to report in an SEC-like manner (for example, prepare Form 10-K and 10-Q reports) even though it is not a registered company with the SEC and is not subject to the requirements of the SEC whose mission is to protect investors.

requirement that SEC registrants use spot rates to discount workers' compensation liabilities.

The DOL calculated the Postal Service's estimated actuarial liability for future workers' compensation benefits as of September 30, 2009, at \$9,507,251,000, which represents 36.1 percent of the total federal liability. It calculated that same liability as of September 30, 2010, at \$10,597,448,000, which represents 37.8 percent of the total federal liability. Thus, the volatility in the DOL figures is much less than that in the Postal Service's figures — \$1.1 billion in FY 2010, rather than \$2.5 billion.

The Postal Service is a component of the government-wide financial statements. We could not determine whether those statements included workers' compensation amounts calculated by the Postal Service or the DOL because the line item in the government financial report does not list liabilities by federal agencies. We believe using DOL's approach for computing discount rates would be more consistent with that of other federal components. Additionally, using the DOL's approach for discount rates may be more logical than following the lead of other SEC registrants, given that private sector liabilities in this area are often shorter term because these companies have the option to settle claims in this area. Postal Service liabilities are more consistent with the federal government liabilities, which can be long term in nature.

Management stated their actuarial and accounting advisors and external auditors have advised them that rates more specific to the Postal Service payout experience provide a better estimate of their liability. Although it is acceptable for the Postal Service to use discount rates different from DOL's, to reduce volatility, the Postal Service should consider using the simple average of 10-year Treasury note rates used by DOL. See [Appendix B](#) for our detailed analysis of this topic.

We recommend the vice president, controller:

1. Evaluate whether to use a simple average of 10-year Treasury note rates similar to the Department of Labor's in order to reduce volatility in the workers' compensation liability.

### **Management's Comments**

Management agreed to consider further alternatives for calculating the liability before the end of Q2, FY 2011. They agreed that using the OMB's forecasted 10-year Treasury rates would likely reduce volatility and be consistent with DOL procedures. However, they advised that they conducted an analysis in Q3, FY 2010 and concluded that proper accounting treatment under GAAP was to discount estimated future payments using Treasury spot rates as of the measurement date, weighted relative to expected cash outflows. In addition, they asserted the Postal Service's IPA would have considered Q3 FY 2010 financial statements in error had management not adopted spot rates. Furthermore, they pointed out that use of either methodology has no impact on future

cash payments and, accordingly, selected the discounting method that best meets accounting standards. See [Appendix C](#) for management's comments in their entirety.

## Evaluation of Management's Comments

The OIG considers management's comments responsive to the recommendation and corrective actions should resolve the issues identified in the report. We recognize the rationale management applied to use the spot rates for the workers' compensation liability estimate. However, we believe management has some latitude in developing the estimated liability, and even though the amount does not impact future cash flows, it does have a direct impact on the reported net income or loss. As the substantial net loss in FY 2010 generated significant publicity and concern, considering a different methodology could be critical to the perception of the Postal Service in these difficult economic times.

## Weights of Actuarial Methods

The Postal Service uses four separate actuarial methodologies to produce four separate undiscounted liability estimates: paid loss development, frequency and severity, expected unpaid, and trended severity methods.<sup>13</sup> The Postal Service has an opportunity to reduce volatility by revising the weights given to the actuarial methods used in the model. Of the four methods, the paid loss development method is the most volatile because the weights differ across injury ages.<sup>14</sup> The loss development method is weighted most heavily for low injury ages, where there is the most volatility; and the frequency and severity method produced the least volatility.<sup>15</sup> Therefore, changing the weighting factors of the methodologies could smooth volatility.<sup>16</sup>

We recommend the vice president, controller:

2. Evaluate how changing the weights of the methodologies impacts the volatility of the workers' compensation liability and, based on the results, consider modifying the weighting factors.

## Management's Comments

Management agreed to consider re-weighting the actuarial methodologies in the future. However, they stated the majority of the volatility results from application of financial accounting principles. They also cautioned that too much emphasis on volatility could

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<sup>13</sup> The *USPS Workers' Compensation – Model Manual* contains descriptions of these methodologies. Also, see [Appendix A](#) for a further description of the methodologies.

<sup>14</sup> Period of time elapsed since the injury occurred.

<sup>15</sup> Based on an analysis performed by IHS Global Insight using undiscounted actuarial estimates by injury age for financial reporting quarters ending June 30, 2007, through December 31, 2009. The liability estimates from the trended severity method are designed to match the loss development method at four points during the initial 10-year injury period. Therefore, we are not comparing the trended severity method here.

<sup>16</sup> An analysis based on changing the weights of the methodologies was beyond the scope of this review.

affect the model's responsiveness to real changes in cost claims. Management added that the weighting in the current model is the product of its decisions to balance stability and responsiveness. Management stated they could not provide a date when reweighting of the actuarial methodologies would be done because such a change would entail a significant programming effort that they believe should only be done in conjunction with other changes to the model to minimize costs.

### **Evaluation of Management's Comments**

The OIG considers management's comments responsive to the recommendation and corrective actions should resolve the issues identified in the report. We recognize reducing volatility should not be the only goal in any updates to the model. Reduction should not be accomplished by forsaking responsiveness or adherence to accounting standards. However, as noted previously, considering a different workers' compensation methodology could be critical to the perception of the Postal Service in these difficult economic times. We further recognize the costs associated with making changes to automated systems. As such, we will continue to monitor the workers' compensation liability and efforts associated with improving its estimate.

### **Management Ownership of the Workers' Compensation Model**

Postal Service personnel responsible for recording the estimated liability for workers' compensation were not sufficiently knowledgeable of the model, including assumptions made, analyses conducted, and rationale for the methods used to develop the liability. Specifically, during our discussions with management, they were unable to provide certain information and answer certain questions regarding the workers' compensation model. For example:

- The outside actuary maintains worksheets calculating the tail factor.<sup>17</sup>
- Management did not know why the paid loss development method was weighted more heavily for low injury ages.
- Management could not tell us how they combine the four actuarial methodologies to produce the liability estimate and stated they do not look at the weighting of methodologies or how the model calculates the liability.

This occurred because management stated it did not have the expertise to understand the model. We believe the Postal Service should have a better understanding of all components of the model.

By better understanding the model, management can ensure it reflects the environment in which the Postal Service operates. For example, the model weighs certain

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<sup>17</sup> The estimated liability for losses payable from claims from 10 years of age until final settlement.

methodologies up to a certain injury age. Once the injury has reached a certain age, the weights applied to the affected methodologies change. If management better understood this weighting approach with respect to actual experience, they would know whether they needed to revise the model. Further, management would be better able to determine when changes to the model are needed. Finally, heavy reliance on a contractor for part of a significant estimate increases the Postal Service's risk of not aligning this estimate with future cash outlays.

We recommend the vice president, controller:

3. Ensure personnel responsible for developing the liability estimate understand the model.

### **Management's Comments**

Management neither agreed nor disagreed with the recommendation, but disagreed with the assertion that it does not sufficiently understand the model's results. They stated they review the model's output every quarter and, for example, their analysis of the tail factor in 2009 resulted in revisions reflected in 2010. They further stated they continually strive to improve their analyses as well as the knowledge of employees responsible for running the model. They also pointed out that an independent actuary who annually certifies as to the reasonableness of the results reported by management reviews the model's results.

### **Evaluation of Management's Comments**

The OIG considers management's comments responsive to the recommendation. Although management disagreed that they did not sufficiently understand the model, they acknowledged the need to strive to improve the quality of their analyses and upgrade the knowledge of employees responsible for running the model. The purpose of the recommendation was to help confirm personnel understood the assumptions and rationale as inputs to the model, not simply its outputs, thereby ensuring the model reflects the environment in which the Postal Service operates. As noted in the report, we found, in certain cases, responsible personnel could not answer technical questions about the model (for example, why the paid loss development method was weighted toward low injury ages). While we still believe management could increase its knowledge and understanding of the model, we acknowledge their efforts to review and analyze the model and the independent actuary's reasonableness review. Accordingly, we will not pursue this issue at this time. We will continue to monitor as part of our ongoing financial statement audit work.

### **Benchmarking**

Overall, the Postal Service follows the same general reporting principles as all reviewed benchmarking organizations. However, compared to the other benchmarked

organizations, the Postal Service presents much more comprehensive information on total size of the liability (both current and noncurrent), estimation methodologies, and modeling assumptions for its workers' compensation liability. The level of detail provided by the Postal Service regarding the estimation and size of its workers' compensation liability is more detailed and transparent than all reviewed organizations. Thus, the Postal Service represents best practices in this area.

Additionally, most other organizations had not revised their discount rate assumptions as dramatically as the Postal Service.<sup>18</sup> In fact, three benchmarking partners used the same discount rate for FYs 2008 and 2009. However, one state government reduced its discount rate used in calculating its workers' compensation liability, contributing to an increase in its liability comparable to the Postal Service. Another organization reported their estimates were sensitive to changes in discount rate assumptions.

### Other Alternatives

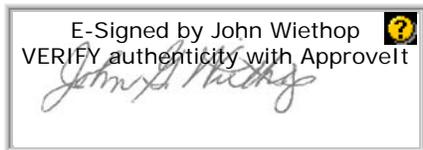
We considered the following alternatives to the Postal Service's liability estimation methodology but determined their resulting impact would not be significant or the change would not be appropriate for the Postal Service:

- Longer term paid loss development averages – the paid loss development method develops the liability using an average of the prior 5 years' of claims history. A longer average (for example 10 years) reduces the weight of each year from 1/5 (20 percent) to 1/10 (10 percent). The difference would not be significant.
- Replace historical medical inflation with future medical inflation assumptions — the difference would not be significant.
- Revise the expected losses to the prior quarter's central estimate — the difference would not be significant.
- Set assumptions of future cost-of-living allowance and medical inflation at a constant differential from future inflation assumptions — this would not be appropriate for the Postal Service because the constant differential from future inflation assumptions does not reflect experience.
- Revise the liability estimate to include a provision for uncertainty. We were unable to identify any guidance associated with this proposal.
- Hedging of rate changes — hedging is not an option for the Postal Service.

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<sup>18</sup> The benchmarking partners provided no information on the assumptions behind their choice of discount rate used; therefore, we could not draw conclusions about the rationale for choosing the discount rate used for workers' compensation liability.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Lorie Nelson, director, Financial Reporting, or me at 703-248-2100.



**for**

John E. Cihota  
Deputy Assistant Inspector General  
for Financial Accountability

Attachments

cc: Joseph Corbett  
Julie S. Moore  
Corporate Audit and Response Management

## APPENDIX A: ADDITIONAL INFORMATION

### BACKGROUND

Compensation for work-related injuries for federal employees falls under the authority of Title 5, U.S.C. Chapter 81, *FECA*.<sup>19</sup> The OWCP within the DOL administers FECA on behalf of the Postal Service. The OWCP's principal responsibilities are to evaluate, adjudicate, and pay claims related to workers' compensation.

FECA provides the following benefits to Postal Service employees who suffer job-related injuries or disabilities:

- Continuation of regular pay for periods of disability as a result of a traumatic job-related injury.
- Compensation for wages lost as a result of job-related injury.
- Medical care for injury or disability that is job-related.
- Vocational rehabilitation.

The DOL sends an invoice to the Postal Service annually for the workers' compensation claims it has paid, processed, and credited. Each 12-month period is known as a chargeback year, ending on June 30. The Postal Service compensates the DOL for administering the program and claims paid. For the chargeback year ending June 30, 2009, reimbursement was \$1,069 million for claims paid and \$54 million for administrative expenses.

The Postal Service is required to account for future workers' compensation costs associated with employees' medical expenses, payments for continuation of wages, and DOL administrative fees not yet paid. In addition, the Postal Service, using an actuarial model, estimates the workers' compensation liability for all future payments to be made to employees injured in previous years and all future payments to employees who have been injured in the current year. IPFC, Inc., constructed the model, first used in Q4, FY 2008. It contains four actuarial methodologies that are combined using a weighted average to produce the estimated liability, as shown in Figure 1.

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<sup>19</sup> Title 5 does not apply to the Postal Service; however, under Title 39, U.S.C. Chapter 1005(c), all Postal Service employees are covered by FECA.

**Figure 1: Four Actuarial Methodologies**

	Methodology	Description	Weights*
1	<b>Paid Loss Development</b>	Forecasting the future payments that will be associated with injuries of various ages, by quarter, up to 40 quarters from the occurrence of injury.	5%-100%
2	<b>Frequency and Severity</b>	Forecasting the number of claims relative to the number of hours worked in a given quarter of injury and the average payment per claim.	0%-31%
3	<b>Expected Unpaid</b>	Forecasting based on the estimated unpaid amounts at 40 quarters plus what has been paid to date.	0%-32%
4	<b>Trended Severity</b>	Applying a selected severity trend rate to compensation and medical claims separately.	0%-32%

\* Weights vary by injury age, from 1-40 quarters.

Source: OIG and *USPS Workers' Compensation – Model Manual*

The actuarial methodologies used are paid loss development, frequency and severity, expected unpaid, and trended severity methods. Estimated liability is based on the assumption that historical claim activity represents a reasonable indicator of future patterns.

In addition, the workers' compensation model, when computing an estimated liability, takes into account discount and inflation rates. Discounts are applied towards future compensation provided to injured employees and medical expenses paid. Discounts are used because they take into account the time value of money (for example, a dollar is worth more today than in the future). Inflation accounts for increases in compensation and medical costs. GAAP requires management to include inflation when calculating present value under certain conditions.

The long-term liability at September 30, 2010, was \$11.6 billion, an increase of approximately \$2.4 billion over FY 2009. As of September 30, 2009, the long-term liability was \$9.1 billion, an increase of \$2.1 billion over FY 2008.

## **OBJECTIVES, SCOPE, AND METHODOLOGY**

Our objectives were to determine whether opportunities exist for economic impact (cost savings) or to improve the workers' compensation model and reduce the volatility of management's workers' compensation liability estimate.

In support of our objectives, we contracted with IHS Global Insight for assistance in reviewing the workers' compensation model for reasonableness of the assumptions

used in computing the estimate. In addition, we examined the model and related documents to evaluate volatility of the model's estimates. Furthermore, we benchmarked with other organizations to identify opportunities for improving the Postal Service's liability estimation process.

Our initial focus was workers' compensation liabilities only. However, due to insufficient responses from these organizations, we expanded our review to include other, similar long-term liabilities. We looked at other organizations to understand how they calculated such liabilities and focused on volatility, transparency, and discount rates. We also inquired as to whether any external influences affected their liability estimates and the extent of any validation of the methodologies used. We limited definitive conclusions on benchmarking findings due to challenges in securing interviews and an inconsistent transparency in reporting workers' compensation liabilities. We obtained 11<sup>20</sup> benchmarked organizations' financial reports for FYs 2008 and 2009 from publicly available annual financial reports; however, we could obtain information on the total workers' compensation liability from only six<sup>21</sup> organizations.

We conducted this review from December 2009 through December 2010 in accordance with the *Quality Standards for Inspections*.<sup>22</sup> We discussed our observations and conclusions with management officials on November 5, 2010, and included their comments where appropriate.

We assessed the reliability of data from the Postal Service workers' compensation model and determined the data were sufficiently reliable for the purpose of this report.

## PRIOR AUDIT COVERAGE

The OIG did not identify any prior audits or reviews related to the objective of this audit.

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<sup>20</sup> The state of New York; University of California; California State Compensation Insurance Fund; New York State Insurance Fund; Washington Metropolitan Area Transit Authority; University of Virginia; University of Michigan; and four Fortune 500 companies.

<sup>21</sup> The state of New York; University of California; University of Michigan; and three Fortune 500 companies.

<sup>22</sup> These standards were last promulgated by the President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE) in January 2005. Since then, The Inspector General Act of 1978 as amended by the IG Reform Act of 2008, created the Council of the Inspectors General on Integrity and Efficiency (CIGIE), which combined the PCIE and ECIE. To date, the *Quality Standards for Inspections* have not been amended to reflect adoption by the CIGIE and, as a result, still reference the PCIE and ECIE.

## APPENDIX B: DETAILED ANALYSIS

### Discount Rates

Effective with Q3, FY 2010, management elected to refine their estimate by developing new discount rates for compensation and medical expense. Formerly, discount rates were developed using a mix of interest rates for selected Treasury securities projected over a 10-year period. For compensation, the discount was a simple average of interest rates of 5-, 10-, and 30-year maturities; and for medical expenses, the discount was a simple average of 90-day and 5- and 10-year maturities. Commencing with Q3, FY 2010 reporting, management began using a weighted average of Treasury spot rates as of June 30, 2010, for 1-, 5-, 10-, 20-, and 30-year notes. Management believed these rates allowed for a better estimate of fair value of the workers' compensation liability at the measurement date. As shown in Figure 2, comparing Q3, FY 2010 to Q2, FY 2010, workers' compensation liability increased to \$11.6 billion (an increase of \$2 billion), resulting primarily from a decrease in the discount rate of 1.6 percent for compensation and 1.5 percent for medical expenses.

**Figure 2: Impact of Change for Discount Rates**

	Q2, FY 2010	Q3, FY 2010	Change
<b>Compensation Claims</b>	5.1%	3.5%	(1.6%)
<b>Medical Claims</b>	4.5%	3.0%	(1.5%)
<b>Total Workers' Compensation Liability (Billions)</b>	\$9.6	\$11.6	\$2.0

Source: Postal Service quarterly 10-Q and annual 10-K financial reports.

We benchmarked with the DOL, the entity that determines both civilian and military agencies' liabilities for future workers' compensation benefits for civilian federal employees as mandated by the FECA. The DOL does not use Treasury spot rates, instead discounting these projected annual benefit payments using a simple average of forecasted 10-year Treasury note rates from the OMB, resulting in less volatility.

The DOL provides liability estimates for projected future workers' compensation benefits to each reporting entity preparing financial statements under the *Chief Financial Officers Act*.<sup>23</sup> The DOL states that each entity should include its respective portion of the actuarial liability for workers' compensation benefits as a liability in its financial statements, if such amounts are material. However, the Postal Service does not use this amount in its financial statements because it applies FASB accounting standards.

<sup>23</sup> The *Chief Financial Officers Act of 1990* (Public Law 101-576), as amended by the *Government Management Reform Act of 1994* (Public Law 103-356), requires annual, audited financial statements for the U.S. Government and its component entities, referred to as federal reporting entities.

The DOL follows FASAB financial accounting standards, which require the use of Treasury borrowing rates for discounting but does not specify a precise method for selecting such rates. There were a number of options for the discount rate; however, the discount rate generally required in FASAB standards is the rate on marketable Treasury securities of similar maturity to the cash flows of the obligation in question.<sup>24</sup> This concept is very similar to FASB standards,<sup>25</sup> which state that a fair value measurement using present value should include the time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows (risk-free interest rate). Treasury securities are deemed risk-free because they pose neither uncertainty in timing nor risk of default to the holder. The Postal Service uses such Treasury investments in its workers' compensation model; however, as noted above, it uses Treasury spot rates, while the DOL uses a simple average of 10-year Treasury notes. The resulting liability using the DOL's approach is less than the liability using the Postal Service's method.

Because the Postal Service is not a public company and does not have shareholders, it is not subject to the requirements of the SEC whose mission is to protect investors. However, the Postal Act of 2006 requires the Postal Service to prepare an annual report containing the information required by the SEC under such sections on Form 10-K.<sup>26</sup> The Board's IPA has interpreted this financial statement requirement to mean the Postal Service needs to comply with SEC guidance. Further, the IPA stated the use of spot rates is consistent with other companies registered with the SEC. They pointed to guidance provided in SEC SAB 92 on discounting of environmental liabilities that in their experience the SEC has suggested be applied in most situations involving the discounting of recorded liabilities. They also expressed their position, consistent with SAB 92 that the discount factor applied should reflect the risk free interest rates applicable to obligations of similar duration as the cash flows of the obligation subject to discounting for accounting purposes. We reviewed publicly available documentation to determine SEC requirements for computing discount rates but were unable to find anything authoritative. Therefore, we contacted an associate chief accountant at the SEC who stated there is nothing authoritative regarding the methodology for computing discount rates. There does not appear to be any direct requirement that SEC registrants use spot rates to discount workers compensation liabilities.

The DOL calculated the Postal Service's estimated actuarial liability for future workers' compensation benefits as of September 30, 2009, at \$9,507,251,000, which represents 36.1 percent of the total federal liability. It calculated that same liability as of September 30, 2010, at \$10,597,448,000, which represents 37.8 percent of the total federal liability.

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<sup>24</sup> *Statements of Federal Financial Accounting Standards 33, Pensions, Other Retirement Benefits, and Other Post-employment benefits: Reporting Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates*, October 14, 2008.

<sup>25</sup> Accounting Standard 820-10-55-5.

<sup>26</sup> The Postal Act of 2006 requires the Postal Service to report in an SEC-like manner (for example, prepare Form 10-K and 10-Q reports) even though it is not a registered company with the SEC, and is not subject to the requirements of the SEC whose mission is to protect investors.

In comparison to private sector companies, the Postal Service's liability is also significantly larger than comparable private sector companies. For example, Wal-Mart reported total self-insured liability of \$3.2 billion at January 31, 2010; United Parcel Service reported \$2.5 billion at December 31, 2009; and FedEx reported \$1.6 billion at May 31, 2010. The length of time a claim remains open can affect the cost of the claim. The Postal Service has claims dating back to the era of the Post Office Department and, since it does not have the authority to settle claims, the resulting liability is greater. As a result, the Postal Service might want to consider whether it makes sense to follow a method used by public companies that can settle claims.

The Postal Service is a component of the government-wide financial statements. We could not determine whether those statements included workers' compensation amounts calculated by the Postal Service or the DOL because the line item in the government financial report does not list liabilities by federal agencies. We believe using the DOL's approach for computing discount rates would be more consistent with that of other federal components.

Management stated their actuarial and accounting advisors and external auditors have advised them that rates more specific to the Postal Service payout experience provide a better estimate of their liability. It is acceptable for the Postal Service to use discount rates different from those of the DOL. However, to reduce volatility, the Postal Service could consider using a simple average of 10-year Treasury note rates similar to what the DOL uses.

In general, the benchmarking partners provided no information on the assumptions behind their choice of the discount rate used; therefore, this analysis cannot draw conclusions about the rationale for the choice of discount rate used for workers' compensation liability.

### [Frequency of Discount Rate Updates](#)

Discount rates used in the liability computation are prepared using interest rates which are impacted by the economic environment. As present economic conditions produce low interest rates, discount rates correspondingly follow and the resulting liability increases. If there is an overall trend in interest rates, volatility is reduced by more frequent updates. Conversely, if the rates fluctuate up and down during a period, more frequent updates can produce significant fluctuations.

Prior to Q3, FY 2009, management had not updated the discount rates used in the workers' compensation model since FY 2007. The liability changes prior to Q3, FY 2009, were fairly stable (as shown in Figure 3). Beginning in Q3, FY 2009, when management elected to update the discount rates each quarter, volatility increased.

**Figure 3: Discount Rates and Changes in Workers' Compensation  
Long-Term<sup>27</sup> Liability Amounts  
FYs 2007 through 2009**

	Compensation Claims		Medical Claims		Changes in Liability (Billions) <sup>28</sup>	
	Rates	Percentage Change from FY 2007	Rates	Percentage Change from FY 2007	Liability	Dollar Change from FY 2007
<b>FY 2007</b>	5.6%	--	5.4%	--	\$6.8	--
<b>FY 2008</b>	5.6%	0.0%	5.4%	0.0%	\$7.0	\$0.2
<b>Q3, FY 2009</b>	4.7%	(0.9%)	4.1%	(1.3%)	\$8.7	\$1.9
<b>Q4, FY 2009</b>	4.9%	(0.7%)	4.4%	(1.0%)	\$9.1	\$2.3

Source: Postal Service quarterly 10-Q and annual 10-K financial reports.

As shown at the end of Q3, FY 2009, discount rates declined by 0.9 percent for compensation and 1.3 percent for medical benefits since the last update in FY 2007. In large part because of the updates in Qs3 and 4, FY 2009, when compared to FY 2007, total workers' compensation liability increased in Q3 by approximately \$1.9 billion and \$2.3 billion in FY 2009.

As shown in Figure 4, management continued to update its discount rates on a quarterly basis. Even though the frequency of changes may lead to greater volatility, depending on the amount of fluctuation in the interest rates, quarterly updates timely inform the Board, management, and others of any trends or significant changes in workers' compensation liability.

<sup>27</sup> Portion of the liability with a future benefit over 1 year.

<sup>28</sup> Amounts may differ due to rounding.

**Figure 4: Discount Rates and Changes in Workers' Compensation  
Long-Term Liability Amounts  
FY 2010**

	Compensation Claims		Medical Claims		Changes in Liability (Billions) <sup>29</sup>	
	Rates	Percentage Change	Rates	Percentage Change	Liability	Dollar Change
<b>Q1, FY 2010</b>	5.0%	0.1%	4.5%	0.1%	\$8.2	(\$0.9)
<b>Q2, FY 2010</b>	5.1%	0.1%	4.5%	0.0%	\$8.5	\$0.3
<b>Q3, FY 2010</b>	3.5%	(1.6%)	3.0%	(1.5%)	\$10.5 <sup>30</sup>	\$2.0
<b>Q4, FY 2010</b>	2.9%	(0.6%)	3.0%	0.0%	\$11.5	\$1.0

Source: Postal Service quarterly 10-Q financial reports and 10-K reports.

Generally, based on assumptions and inputs used for Q3, FY 2010, a 1 percent decrease in the discount rate of future compensation and medical payments increases the liability by approximately \$1.3 billion, and a 1 percent increase results in a decrease of about \$1.0 billion.

Our benchmarking efforts disclosed that most other organizations had not revised their discount assumptions as dramatically as the Postal Service. In fact, three benchmarking partners used the same discount rate for FYs 2008 and 2009; however, one state government reduced the discount rate it used in calculating its workers' compensation liability. In 2008, the rate was 4.17 percent and declined in 2009 by 0.92 percent to 3.25 percent. This decrease in the discount rate contributed to a 26.2 percent increase in its total workers' compensation liability, similar to the Postal Service's 27.2 percent increase for Q3, FY 2009, as shown in Figure 5.

<sup>29</sup> Amounts may differ due to rounding.

<sup>30</sup> This also includes a change from forecasted discount rates used as a proxy for current market rates to weighted average Treasury spot discount rates for Q3, FY 2010.

**Figure 5: Comparison of Postal Service and a Benchmarking Partner's  
Workers' Compensation Total Liability**

	Total Workers' Compensation Liability		Percentage Change
	FY 2008 (in millions)	FY 2009 (in millions)	
<b>Postal Service</b>	\$7,968	\$10,133	27.2%
<b>Benchmarking Partner</b>	\$1,985	\$2,505	26.2%

Source: Postal Service annual 10-K quarterly reports and the state of New York.

**APPENDIX C: MANAGEMENT'S COMMENTS**

VINCENT DeVITO  
VICE PRESIDENT, CONTROLLER



December 20, 2010

LUCINE WILLIS

SUBJECT: Workers' Compensation Liability Estimate (Report Number FT-MA-11-DRAFT)

Attached is the management response to the draft audit report cited above. The audit report and management's response do not contain information that may be exempt from disclosure under FOIA.

A handwritten signature in black ink, appearing to read "V. DeVito".

Vincent DeVito

Attachment

cc: Joseph Corbett  
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Recommendation 1

Management agrees to consider further alternatives to the fair value methodology used to calculate the workers' compensation liability before the end of Quarter 2, FY 2011. Management initially conducted such an analysis in Quarter 3, 2010. This analysis led to the conclusion that the proper accounting treatment under generally accepted accounting principles (GAAP) is to discount the estimated future payments using Treasury spot rates as of the measurement date, weighted relative to the expected cash outflows. The applicable GAAP is found primarily in Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures.

Although using OMB's forecast of 10-year Treasury rates to discount the workers' compensation liability would likely reduce volatility and would be consistent with the Department of Labor (DOL), this may not be in accordance with the fair value accounting requirements in GAAP. Since OMB's forecasts, to the best of our knowledge, are not refreshed quarterly, current rates would not be available when our 10-Qs are filed. This means that discount rates would only be updated annually. The Board of Governors' Independent Public Accountant informed the Audit and Finance Committee that, had management not adopted spot rates in the Quarter 3 financial statements, they would have considered those financial statements to have been in error. In addition, although updating discount rates annually would eliminate quarterly volatility, it would compress all the remaining volatility into the last quarter of each fiscal year. Based on the differential between the rates used in 2009 and 2010, this could mean that a change in the liability of \$400 million to \$600 million could occur.

It is important for the reader of this report, and the reader of the Postal Service financial statements to understand that the choice of discount rates in estimating the liability has no economic impact. Whether the Postal Service uses spot rates or forecast rates has absolutely no impact on the future cash payments that the Postal Service makes to the DOL. Since there is no cash flow impact from the discounting methodology used, management has chosen to utilize a discounting methodology which best meets the spirit of the fair value account requirements embodied in ASC 820.

Target Implementation Date

Management's additional analysis and briefing of the Audit and Finance Committee will be accomplished by the end of Quarter 2, FY 2011.

Responsible Official

Manager, Corporate Accounting

Recommendation 2

Evaluate how changing the weights of the methodologies impacts the volatility of the workers' compensation liability and, based on the results, consider modifying the weighting factors.

Management's Response

Management agrees to give consideration to re-weighting the actuarial methodologies in the future. However, it must be understood though that the vast majority of the volatility in reported workers' compensation expense relates to the application of fair value accounting principles in accordance with ASC 820, which would not be affected at all by reweighting the model. It must be further understood that eliminating volatility should not be the sole goal of any future changes to the liability estimation model. The weighting of the methodologies in the current model is the product of management decisions to balance stability and responsiveness. If too much emphasis is placed on reducing volatility, then the model may not be sufficiently responsive to real changes in the number or cost of claims, because the impact of new data would be muted.

Target Implementation Date

The date by which management would complete any reweighting of the actuarial methodologies employed in the model is unknown at this time. A change such as this requires a significant programming effort and would only be undertaken in conjunction with other changes to model in

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order to minimize costs. Financial and programming resources are currently severely constrained at the Postal Service, thus we cannot set a deadline as to when any programming changes will be made to the model.

Responsible Official  
Manager, Corporate Accounting

Recommendation 3  
Ensure personnel responsible for developing the liability estimate understand the model.

Management's Response  
Management disagrees with the assertion that it does not have the necessary expertise to understand the results produced by the model. The model is designed by actuaries, using actuarial principles and practices, based on design parameters specified by postal management. The weighting of actuarial methodologies, as noted above, was based on management's specific directions regarding the need to balance responsiveness and predictability. Postal management carefully reviews the output of the model every quarter compared both to inputs, history and forecasted results. For example, management's review and analysis of increases in the tail factor in 2009 resulted in revisions to that estimate made in 2010 based on the analysis additional data. Obviously, the development of the workers' compensation liability estimate is extremely complex, and management continually strives to improve the quality of its analyses and upgrade the knowledge of employees responsible for running the model. Additionally, it must be pointed out that the Postal Service's model results are reviewed by an independent actuary who annually certifies as to the reasonableness of the results reported by management.