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Could You Be Sponsoring a Hidden Retiree Medical Plan?

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Sponsoring a hidden retiree medical plan happens more often than you might think. Having even an informal policy of extending active medical coverage to retirees and charging the "full" active premium or supplementing coverage for a period of time are two examples of creating a retiree medical plan and incurring the accompanying liability for benefits promised in the future.

Examples

1) ABC Company has a fully insured medical plan for their active employees. ABC pays 60% of the premium. The employees pay the rest. The employee handbook has a paragraph that reads, "If you retire from active service after age 60 with 15 years of service, you may remain in the health insurance plan until age 65. You will pay the employer and employee portion of the premium."

2) Ten years ago XYZ Company had an executive retire at age 60. He had been with the company for 17 years. He was allowed to stay on the active medical plan until age 65. He had to pay the employer and employee portion of the premium. An email was sent at the time to all staff stating that this was now available to all employees who retire after age 60 with 15 years of service. The language in the email never made it in the employee handbook but it was a well-known policy.

3) MNO Corporation has a collective bargaining agreement with their union that provides $150 per month for medical coverage for anyone who retires before age 65. Coverage ends at age 65, and the participants must purchase the coverage from MNO.

ABC, XYZ, and MNO have retiree medical plans and might need to recognize a liability on their balance sheets and annual expense on their income statements for the promised benefits.

Why is There a Liability?

The question asked for ABC and XYZ is, "The retiree pays the full cost of the premium. It costs the company nothing. Why is there a liability?"

There are two parts to the answer. The first part is in the way the premiums are calculated for the active medical plan. The insurance company calculates the premium rates for the entire population. This includes the retirees. Since these retirees are older, their premium amounts are higher than for younger employees in the plan. Without the retirees in the plan, the total premium would be lower and thus the employer portion would be lower.

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Looked at another way, if you could calculate a hypothetical premium rate for just the retiree group, it would be much higher due to their ages. The difference between the hypothetical premium level and the "full" active premium they are being charged for medical coverage is called a "hidden subsidy."

The second part is from the accounting standard ASC 715-60-05-2 which states, "a postretirement benefit plan is an arrangement that is mutually understood by an employer and its employees whereby an employer undertakes to provide its current and former employees with benefits after they retire in exchange for the employees' services over a specific period of time."

This second part of the above answer also applies to MNO. Their annual cost for the retirees may seem minimal and may be recorded as an annual payroll and benefits cost along with the active medical plan. However, for all three companies, the retirees are not receiving benefits as a part of their compensation while working. The retiree benefits are accrued while working, but are paid after retirement.

This promise of future benefits can trigger a liability that needs to be recognized on the balance sheet and an annual expense that runs through the income statement.

How Does an Employer Know if They Need to Recognize a Liability?

The employer should discuss it with their auditors. Depending on the circumstances, an auditor could consider it de minimus, or may request that an actuary measure the liability before providing an opinion about the impact on the company financials.

Options

If the auditor does not consider it de minimus, in arrangements like ABC's or XYZ's, a company could charge the retiree more than the active premium – something more like the above hypothetical premium. (An actuary or healthcare consultant can help you set a hypothetical rate.) This would remove the "hidden subsidy" and reduce the costs to de minimus level. Additionally, the increased cost of coverage may cause retirees to look elsewhere for more affordable coverage.

Alternatively, if the employer wants to keep an arrangement that is not de minimus, then it will need to engage an actuary to perform annual valuations for financial reporting purposes.