Market trends in retiree healthcare and financial reporting implications

April 30, 2014

In brief

The Affordable Care Act (ACA) has created a lot of buzz about healthcare exchanges. Most recently the enrollment period opened for individuals to purchase insurance on public exchanges. These individuals may be unemployed, actively employed, or retired and not yet eligible for Medicare. Some of them, if they have low-income, may be eligible for government assistance to help pay for their coverage on the public exchanges. ACA has also created an interest in private exchanges for both active employees and retirees. Although private exchanges that offer individual plans to Medicare-eligible retirees have been available for several years, there has been a renewed interest in these exchanges as an alternative means of providing retiree healthcare coverage. The increased attention due to these recent developments, coupled with a continued focus by employers on ways to mitigate rapidly rising retiree healthcare costs, has accelerated changes in the design of retiree healthcare benefit plans. This Insight focuses on the accounting implications of such changes.

In detail

Background

In 2010, ACA was signed into law with the goals of increasing access to healthcare, improving affordability, and improving quality. Health insurance exchanges and Medicaid expansion are the primary vehicles to increase access. Government subsidies for low-income individuals and increased transparency and competition through online exchanges are how ACA aims to improve affordability. New health benefit standards that provide a minimum level of coverage are intended to improve quality.

Private exchanges came first and are growing. Through the private exchanges, employers can provide coverage alternatives for their active employees, pre-65 retirees, and post-65 retirees. Several major benefits consulting firms and insurance companies, as well as other organizations, operate private exchanges, which offer a range of coverage options at various prices. They may also provide consulting services and administrative support for employees and retirees to assist them with plan selection. The state or federally-operated public health insurance exchanges are open to individuals buying their own coverage and employees of firms with 100 or fewer workers (50 or fewer in some states).

The post-credit-crisis economy, coupled with continually increasing healthcare costs, has driven many companies to implement cost cutting measures, including measures to reduce healthcare costs. Several household name companies recently announced they will be shifting benefits from traditional employer-sponsored group health plans to the private exchanges for participants who are 65 and older. Many of these companies will provide their retirees with a fixed subsidy to help pay for the insurance premiums on these exchanges. Others have chosen

to provide no subsidy or to eliminate retiree health-care benefits entirely.

Accounting for changes to retiree healthcare benefits

A move to the private exchanges as an alternate means of providing health insurance coverage for a retiree population will likely result in some sort of change to the financial aspects of the retiree healthcare benefit plan. This change could range from an alternate level of subsidy from the employer to the outright termination of the program. This section addresses the financial reporting implications of some changes an employer may be considering. We've focused on some of the more common plan design changes that companies are making, and the potential financial reporting implications of each.

Elimination of retiree healthcare coverage

Accounting Impact	Yes	No	Maybe
Negative plan amendment	√		
Actuarial gain/loss		√	
Curtailment			√
Settlement		√	

An employer may eliminate retiree healthcare benefits for all current and future retirees without providing any substitute compensation to employees or retirees. In other cases, the employer may amend its plan to provide a reduced level of benefit for some period, say, two years, until ultimate wind-down of the plan. In such a case, the plan would need to be remeasured. As a result of the reduction in benefits, the remeasured plan obligation is reduced, often significantly, since only two additional years of benefits will be provided.

The reduction of the plan's obligation would be accounted for as a negative plan amendment. Under the delayed recognition rules for postretirement benefit plan accounting, this negative amendment would be recognized in other comprehensive income (OCI) and subject to amortization over future periods.

Observation

Employers should carefully consider the possibility that a negative plan amendment might later be reversed, for example, as a result of litigation against the employer on behalf of the plan's participants, particularly retirees, seeking reinstatement of the prior level of benefits. If it's probable the negative plan amendment will be rescinded, then the retiree healthcare obligation should not be reduced by the effects of the negative plan amendment. If rescission is not probable, the facts and circumstances may represent a contingent liability requiring disclosure. This example assumes no portion of the benefit that has been reduced is attributable to future services, which would be subject to curtailment accounting.

Generally, the effect of a plan amendment on the plan's obligation is amortized over the remaining years of service to the full eligibility date for active employees expected to receive benefits. If all or almost all plan participants are fully eligible for benefits, the effect of the plan amendment is amortized over the remaining life expectancy of the participants. However, in this case where the plan will be terminated (i.e., the benefit will be eliminated for all participants) with an effective date two years in the future, employers should consider whether to recognize the impact of the negative amendment over the period from the date of the amendment to the expected date of plan termination. Likewise, recognition of deferred actuarial gains/losses over the two-year period to the expected wind-up date of the plan may also be appropriate.

Observation

For self-insured plans, employers that intend to terminate their benefit programs should consider the fact there may still be an obligation to pay incurred but not reported (IBNR) costs. Employers will need to determine whether it is appropriate to account for these obligations under ASC 715-60.

Curtailments

The negative plan amendment reduces or eliminates benefits already earned by plan participants for past services. Since the amendment may also eliminate the accrual of defined benefits for some or all future service of a significant number of employees, a curtailment may also have occurred. A curtailment (of a postretirement benefit plan) is an event that significantly reduces the expected years of future service of active plan participants or eliminates the accrual of defined benefits for some or all of the future services of a significant number of active plan participants. The net gain or loss resulting from the curtailment should be measured and recognized when the employer amends its plan, and not when the plan termination is effective. The postretirement benefit guidance includes detailed rules on how the gain or loss associated with a curtailment is determined.

Settlements

Because of the nature of retiree healthcare obligations, settlements are unusual. A settlement of a postretirement benefit obligation is a transaction that is an irrevocable action, relieves the employer (or the plan) of primary responsibility for a pension or postretirement benefit

obligation, and eliminates significant risks related to the obligation and the assets used to effect the settlement. Generally, unless the settlement results from a sale of a portion of a business, there must be an exchange of cash (or other assets) in order for a settlement to occur (e.g., employer pays lump sums to participants in exchange for the participant's right to receive retiree healthcare benefits).

If the plan is simply being wound-down and discontinued, and no payment is being made to transfer the plan obligation to a third-party, no settlement gain or loss will be recognized. Upon final termination of the plan, any remaining deferred amounts in accumulated other comprehensive income (AOCI) associated with the plan should be recognized in income.

Change in employer subsidy to a fixed amount

Accounting Impact	Yes	No	Maybe
Negative plan amendment			√
Actuarial gain/loss			√
Curtailment		√	
Settlement		√	

Many employers that shift benefits from traditional employer-sponsored group health plans to the private exchanges will continue to provide some sort of subsidy to their retirees, often a fixed annual amount in a retiree Health Reimbursement Account (HRA). From a cost perspective, the employer obligation has changed from covering the claims and administrative costs (if self-insured) or premium costs (if insured) not paid for by retiree contributions, to providing a fixed annual subsidy. In this case, the nature of the benefit obligation has changed, from an often less predictable cost to a more predictable defined dollar subsidy. Even though the employer may have reduced some of its risk and uncertainty, the arrangement continues to represent a defined benefit plan. As participants will continue earning defined benefits, benefits have not been eliminated nor have the plan participant's expected years of future service been significantly reduced, therefore no curtailment occurs. Likewise, since the employer is not making any payment to transfer the liability associated with the original benefit promise, there is no settlement.

It's likely that, as a result of the plan change, there will be some change in the expected costs to the employer. Some judgment may be required in assessing whether this is more akin to a plan amendment or to an actuarial gain/loss. Plan amendments are typically the result of an economic decision by the employer to grant increased (or decreased) plan benefits.

If there is expected to be a more than insignificant change in the cost of providing benefits, this may indicate the change is more akin to a negative plan amendment. In this case, as described previously, recognition of the impact on the plan's obligation would be deferred and amortized, generally over the average remaining years of service to the full eligibility date for active participants.

If the change is insignificant it may be viewed as more akin to an actuarial gain or loss. In this case, the impact of any change in the plan liability would be treated as a gain/loss recognized in OCI, and subject to amortization following the company's policy for gain/loss recognition.

Observation

If the change is assessed to be more akin to an actuarial gain/loss rather than a plan amendment, interim remeasurement of the plan likely would not be required. Actuarial gains/losses are generally not considered 'significant events' that would call for remeasurement.

The accounting would not be affected by whether a retiree participates in an exchange. The substance of the arrangement is the same in either case. That is, the employer is replacing a promise to provide healthcare benefits during retirement with a promise to subsidize the retiree's cost of obtaining health care benefits.

Retiree dropout assumption

Over time, companies have been shifting a larger portion of the cost of retiree healthcare benefits to the participants. As a result, the level of plan participation has steadily declined. This effect is most noticeable in situations where the employer subsidy levels are capped, and the retirees are required to pay the entire excess of expected costs over the subsidy. In these situations, it is not atypical for an employer when estimating the cost of providing the subsidy to use an actuarial assumption anticipating future dropouts among the current participant population. This is often called the dropout rate.

Under a typical private exchange solution for Medicare eligible retirees, the underlying plans from which the retirees can choose are the same plans they can find themselves on the individual market. If an employer provides a fixed subsidy for retirees to use in obtaining coverage, this provides an additional incentive for the retirees to remain in the plan. They can drop out of the plan, find individual coverage on the open market, and pay for the entire cost themselves, or they can stay in the plan and receive an employer subsidy for that same coverage.

Observation

Employers that use a retiree dropout assumption should re-assess the appropriateness of that assumption under a private exchange scenario and consider the effects of the revised assumption when measuring expected retiree healthcare costs under that scenario.

The takeaway

Companies are likely to continue to shift away from employer sponsored plans or move to private exchanges for retiree benefits, similar to the shift over the last decade from defined benefit pension arrangements to defined contribution plans. As companies make these changes they should consider the substance of the change and the related accounting implications.

Let's talk

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