Accounting for the Implicit Rate Subsidy in OPEB Plans

By
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Implicit rate subsidies in OPEB (Other Postemployment Benefit) plans received significant attention in the Governmental Accounting Standards Board Statements No. 43 and No. 45 (GASB 43/45). Implicit rate subsidies are not a new topic, as some OPEB plans have recognized their significance since the beginning of OPEB financial disclosure in Statement of Financial Accounting Standards No. 106 (SFAS 106). This article will illustrate that when the implicit rate subsidy is recognized in a plan's obligations, an offsetting implicit subsidy contribution should also be recognized, in order to maintain balance in the financial disclosure information. This is most clearly illustrated by describing the issue in the SFAS 106 environment. Clearly, recognition of a similar implicit subsidy contribution may also be developed for the GASB 43/45 environment.

For some plans it may be quite clear that there is significant impact of an implicit rate subsidy in its measured SFAS 106 obligations. What is not as clear is how that plan should recognize the employer's "implicit subsidy contributions." This article will illustrate a method to recognize the implicit subsidy contribution. Two examples will also be given to distinguish a difference in possible financial disclosure for an employer who pays 100 percent of the active employee group health premiums (and thereby is paying 100 percent of the implicit rate subsidy) compared to an employer who pays only a fraction, say 60 percent, of the active employee premium (thereby paying only a fraction of the subsidy). When active employees are paying a portion of the group health premium, they are in fact paying a portion of the subsidy.

The **implicit rate subsidy** is often described as follows:

> It is a common practice for employers to permit retired employees (and their spouses or dependents) to continue in the employer's group health insurance plan (which also covers active employees) by paying the group premium charged to active employees once eligibility for employer paid benefits is exhausted. This practice creates an OPEB liability based on the theory that retirees have higher utilization of health care benefits than active employees. Unless the premium rate for retirees is set to fully recover their health costs, the premium for active employees is implicitly overstated to subsidize utilization by retirees. Similarly, unless the premium rate for retirees is set to fully recover their health costs, the premium for retirees is understated. This difference creates an implicit rate subsidy.
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> This rate subsidy is considered a benefit that should be included in OPEB valuations (both for SFAS106 and GASB 43/45).
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> The OPEB obligation normally includes the cost of the implicit rate subsidy for the years in which the retiree is paying the active employee insurance costs for continued coverage. When the retiree is eligible for Medicare, the actual cost of coverage is much closer to the premium cost. Therefore, there is no OPEB liability assumed for Medicare-eligible retirees paying 100 percent of the premium.

Please note that an OPEB obligation for the employer results from the implicit rate subsidy whether the retiree pays the full premium or the employer pays part or the entire premium for the retiree.

By reviewing basic principles we can establish the need for the implicit subsidy contribution in our accounting for the plan. First, before a benefit plan is ever established, the value of the plan obligations, plan assets and accrued benefit cost are $0. Similarly, after a benefit plan is completely terminated (all obligations have been fulfilled and all assets have been distributed) the valued plan's obligations, assets and accrued benefit cost are also $0. This is inherent to the accounting principles for balancing the financial disclosure of the plan's obligations, assets and costs. However, if during the course of the plan's operation, accounting recognition occurred only for the obligations and accruing costs of the implicit rate subsidy and not the offsetting value of the realized implicit subsidy contributions, then an accrued benefit cost becomes established which is never extinguished in the accounting statement, even after the plan is terminated. Therefore, such an accounting approach would be out of balance because an accrued benefit cost will still exist even after the plan is terminated thus violating a basic principle. In order to maintain proper balance in financial disclosure, the plan's implicit subsidy contribution should be recognized.

The method for reconciling the Accrued Benefit Cost should include an adjustment for the employer's portion of the implicit subsidy contribution. This implicit subsidy contribution for the general subsidy described above is the expected claim costs (including age-adjustment) for actual pre-65 retirees and dependents in excess of group premiums paid. Premiums and benefits paid directly by the employer are already credited as employer contributions in the reconciliation of the Accrued Benefit Cost. Likewise, a contribution credit for the Accrued Benefit Cost reconciliation should be established for the actual implicit subsidy contribution occurring during the fiscal year.

The implicit subsidy contribution should reflect only the subsidy for the actual pre-65 retirees and dependents. It would not be correct to reflect the expected claim payments during the year as these include amounts for actives expected to retire during the year who may not actually retire. The obligation for actives expected to retire, who didn't actually retire, will be accounted for in unrecognized net actuarial gains/losses (usually a gain).

The reconciliation of the Projected Benefit Obligation (PBO) for the year should also treat the implicit subsidy contribution in the same manner as it treats actual benefit payments because this reflects the actual fulfillment of a plan obligation. By making this adjustment to the reconciliation of the PBO, the resulting Unrecognized Actuarial Gain/Loss will reflect the correct amount to balance the PBO to the Accrued Benefit Cost.

For good measure, the reconciliation of plan assets for the year may reflect both the implicit subsidy contribution as a credit to assets and an equal and offsetting "benefit payment" as a charge resulting in no net change to the actual plan assets. By reflecting these adjustments in the reconciliation of plan assets, the overall impact in the financial disclosure is balanced. See Exhibit 1 for a general illustration which reflects the adjustments described for the implicit subsidy contribution and PBO implicit subsidy fulfillment. The information provided represents a hypothetical employer statement.

By establishing the additional credit for the implicit subsidy contribution in the Accrued Benefit Cost, the reporting is consistent and the accounting balance is preserved.

Two Contrasting Examples:

It is easiest to identify the implicit rate subsidy when the employer pays 100 percent of premium for active employees because it is clear that the employer alone bears 100 percent of the subsidy. However, many plans require employees to pay a portion of the active premium. When the active employees pay a portion of the health premium, they are essentially paying a portion of the subsidy. In the case where the employer pays 60 percent of the active employee premium, the proper implicit rate subsidy should reflect only 60 percent of the total subsidy.

The two examples below illustrate the difference in financial disclosure for an employer who pays 100 percent of the subsidy compared to an employer who pays a fraction of the active premium (60 percent is used in the example) and permits the remaining premium (40 percent) to be paid by active employees and retirees. In both examples the total premiums are $12,000 and the total expected claims (after age adjustment at 4.0 percent per year) are $25,920. In the case of the employer paying 60 percent of the contribution, the resulting implicit subsidy contribution is just 60 percent of the total as the retirees (and active employees) are funding 40 percent of the implicit rate subsidy.

The examples illustrate the implicit subsidy contributions for an employer with two retirees ages 57 and 62. The average age of the covered employees is 40. The active employee monthly premium is $500.

1. Employer pays 100 percent of premium for active employees
    a. For a retiree age 57, the claim cost is 1.04^17 = 195 percent of the age 40 premium.
    b. For a retiree age 62, the claim cost is 1.04^22 = 237 percent of the age 40 premium.
    c. Claim costs expected for 2 retirees = 12 x 500 x (1.95 + 2.37) = $25,920
    d. Premiums paid by employer for 2 retirees = 12 x 500 x 2 = $12,000
    e. Implicit subsidy contribution for 2 retirees = $25,920 - $12,000 = $13,920

2. Employer pays 60 percent of premium for active employees (and retirees also covered under the active group health plan)
    a. Premiums paid by employer for 2 retirees = $12,000 x 60 percent = $7,200
    b. Premiums paid by 2 retirees = $12,000 x 40 percent = $4,800
    c. Implicit subsidy contribution for 2 retirees = ($25,920 x 60 percent) - $7,200 = $8,352

Exhibit 1
Annual Summary of SFAS 106 Financial Accounting Information

Fiscal Year Ending: 12/31/200X	Plan's Funded Status			Items Not Fully Recognized In Sponsor's Financial Statement			Amounts per Sponsor's Books	
	Projected Benefit Obligation	Plan Assets at Fair Value	Funded Status: Over/(Under) Funded	Unrecognized Net(Gain) or Loss	Unrecognized Prior Service Cost	Unrecognized Net Transition Obligation	Accrued Postretirement Benefit Cost	Net Periodic Postretirement Benefit Cost
Balance at end of prior year	$ (1,100,000)	$ 100,000	$(1,000,000)	$ (0)	$ 0	$ 0	$ 1,000,000	
Changes in funded status:								
Service cost	(50,000)		(50,000)					$ 50,000
Interest Cost	(66,000)		(66,000)					66,000
Actual return on plan assets		7,000	7,000					(7,000)
Contributions to plan		100,000	100,000				100,000	
Employer implicit subsidy contribution		13,920	13,920				13,920	
Benefits paid	30,000	(30,000)	0					
Implicit rate subsidy fulfilled	13,920	(13,920)	0					
Plan amendments					(0)			
Liability gains and (losses)								
Experience gains and (losses)	(0)		(0)	(0)				
Assumption changes	(0)		(0)	(0)				
Sponsor's net amortization and deferral:								
Gain or loss:								
Asset gain or loss deferred				(0)				0
Amortization of unrecognized net gain/loss				(0)				0
Amortization of unrecognized prior service cost					(0)			0
Amortization of unrecognized transition obligation						(0)		0
Net periodic postretirement benefit cost							(109,000)	$ 109,000
Balance at end of current year	**$ (1,172,080)**	**$ 177,000**	**$ (995,080)**	**$ 0**	**$ 0**	**$ 0**	**$ 995,080**	

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