

PROPOSED FASB STAFF POSITION

No. FAS 106-b

Title: Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003

Comment Deadline: April 12, 2004

1. This Board-directed FASB Staff Position (FSP) provides guidance on the accounting for the effects of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act), for employers that sponsor postretirement health care plans that provide prescription drug benefits.¹ This FSP also requires those employers to provide certain disclosures regarding the effect of the federal subsidy provided by the Act (the subsidy).

2. This FSP supersedes FSP FAS 106-1, “Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003.”

Scope

3. The guidance in this FSP related to the accounting for the subsidy applies only to the sponsor of a single-employer defined benefit postretirement health care plan for which (a) the employer has concluded that prescription drug benefits available under the plan are “actuarially equivalent” and thus qualify for the subsidy under the Act and (b) the expected subsidy will offset or reduce the employer’s share of the costs of postretirement prescription drug coverage provided by the plan. This FSP also provides guidance for the disclosures about the effects of the subsidy for employers that sponsor postretirement health care benefit plans that provide prescription drug coverage but for which the employer has not yet determined actuarial equivalency. This FSP does not address the accounting for the subsidy in situations that may arise in which the expected subsidy exceeds the employer’s share of the costs of postretirement prescription drug coverage. It also does not address accounting for the subsidy by multiemployer health and welfare benefit plans or by the sponsors or participating employers of those plans.

Background

4. On December 8, 2003, the President signed the Act into law. The Act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least

¹ This FSP makes reference to various provisions of the Act, and, in many cases, paraphrases those provisions. While those statements reflect the best efforts of the FASB staff to describe relevant aspects of the Act, nothing in this FSP should be considered a definitive interpretation of any provision of the Act for any purpose.

actuarially equivalent to Medicare Part D. Questions have arisen regarding whether an employer that provides postretirement prescription drug coverage should recognize the effects of the Act on the plan's accumulated postretirement benefit obligation (APBO) and the employer's postretirement benefit costs and, if so, when and how to account for those effects.

5. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, addresses employers' accounting for postretirement health care benefits. Paragraph 35 of Statement 106 states:

In principle, an employer's share of the expected future postretirement health care cost for a plan participant is developed by reducing the assumed per capita claims cost at each age at which the plan participant is expected to receive benefits under the plan by (a) the effects of coverage by Medicare and other providers of health care benefits, and (b) the effects of the cost-sharing provisions of the plan (deductibles, copayment provisions, out-of-pocket limitations, caps on the limits of the employer-provided payments, and retiree contributions).¹⁴ The resulting amount represents the assumed net incurred claims cost at each age at which the plan participant is expected to receive benefits under the plan. If contributions are required to be paid by active plan participants toward their postretirement health care benefits, the actuarial present value of the plan participants' future contributions reduces the actuarial present value of the aggregate assumed net incurred claims costs.

¹⁴ In some cases, retiree contributions are established based on the average per capita cost of benefit coverage under an employer's health care plan that provides coverage to both active employees and retirees. However, the medical cost of the retirees may cause the average per capita cost of benefit coverage under the plan to be higher than it would be if only active employees were covered by the plan. In that case, the employer has a postretirement benefit obligation for the portion of the expected future cost of the retiree health care benefits that are not recovered through retiree contributions, Medicare, or other providers of health care benefits.

6. Paragraph 40 of Statement 106 states:

Certain medical claims may be covered by governmental programs under existing law or by other providers of health care benefits.¹⁷ Benefit coverage by those governmental programs shall be assumed to continue as provided by the present law and by other providers pursuant to their present plans. *Presently enacted changes in the law* or amendments of the plans of other health care providers that take effect in future periods and that will affect the future level of their benefit coverage *shall be considered in current-period measurements* for benefits expected to be provided in those future periods. Future changes in laws concerning

medical costs covered by governmental programs and future changes in the plans of other providers shall not be anticipated. [Emphasis added.]

¹⁷ For example, a retiree's spouse also may be covered by the spouse's present (or former) employer's health care plan. In that case, the spouse's employer (or former employer) may provide either primary or secondary postretirement health care benefits to the retiree's spouse or dependents.

7. Medicare existed when Statement 106 was issued, and pursuant to paragraph 35, Medicare coverage should be considered in measuring the APBO and net periodic postretirement benefit cost. Changes in coverage provided by that "governmental program" should be considered under paragraph 40 in the period that the law is changed. However, the Act introduces two new features to Medicare that an employer needs to consider in determining those measurements: (a) a subsidy that is based on 28 percent of an individual beneficiary's annual prescription drug costs between \$250 and \$5,000 (subject to indexation and the provisions of the Act as to "allowable retiree costs")² and (b) the opportunity for a retiree to obtain a prescription drug benefit under Medicare.

Federal Subsidy

8. An employer's eligibility for the 28 percent subsidy depends on whether the prescription drug benefit available under its plan is at least "actuarially equivalent" to the Medicare Part D benefit. At present, detailed regulations necessary to implement the Act have not been issued, including those that would specify the manner in which actuarial equivalency must be determined and the evidence required to demonstrate actuarial equivalency.³ In addition, the magnitude of the subsidy for an employer depends on how many of the employer's Medicare-eligible retired plan participants choose not to enroll in the *voluntary* Medicare Part D plan. Further, specific regulations regarding the documentation requirements and payment/reimbursement mechanism for the subsidy are yet to be defined by the appropriate administrative agency. Accordingly, questions have been raised regarding whether the subsidy is substantively similar to other Medicare benefits that existed when Statement 106 was issued and, therefore, should be accounted for as a reduction of the APBO and net periodic postretirement benefit cost, or whether the subsidy represents a payment to the employer that is determined by reference to its plan's benefit payments but is not, in and of itself, a direct reduction of postretirement benefit costs. Under either view, there is also a question as to when the subsidy should be given accounting recognition.

Effect on Per Capita Claims Cost

9. Regardless of the impact of the subsidy, the existence of prescription drug coverage under Medicare Part D may have an effect on an employer's per capita claims cost for a plan that currently provides a prescription drug benefit. That effect depends on (a) whether current and future retirees (or their beneficiaries under the employer-sponsored

² New Section 1860D-22(a) of the Social Security Act created by Section 101 of the Act.

³ Section 1860D-11(c) of the Social Security Act, as amended by the Act, states that "the Secretary [of Health and Human Services] shall establish processes and methods for determining the actuarial valuation of prescription drug coverage."

plan) enroll in the voluntary Medicare Part D plan and (b) the Act's macro socioeconomic effects on health care cost trends and consumers' behavior.

Plan Amendments

10. In response to the Act, or for other reasons, an employer may amend an existing plan (or establish a new one). To the extent that an employer amends a plan (positively or negatively), the APBO will be affected by the direct effects of the change in benefits attributed to employee services already rendered. If an amendment changes the determination as to the actuarial equivalency of benefits available under the plan, the expected subsidy to the employer also will change.

Income Tax Accounting

11. The Act excludes receipt of the subsidy from the taxable income of the employer for federal income tax purposes.⁴ Accordingly, this FSP addresses how that provision affects the accounting for the temporary difference related to the employer's accrued postretirement benefit cost under FASB Statement No. 109, *Accounting for Income Taxes*.

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12. Paragraph 35 of Statement 106 specifies that health care coverage provided by Medicare should be taken into account in measuring the employer's postretirement health care benefit obligation. Paragraph 40 of Statement 106 requires presently enacted changes in relevant laws to be considered in current period measurements of net periodic postretirement benefit cost and the APBO. Therefore, under that guidance, measures of the APBO and net periodic postretirement benefit cost on or after the date of enactment should reflect the effects of the Act.

Effect of the Subsidy on Benefits Attributable to Past Service

13. When an employer initially accounts for the subsidy pursuant to the effective date and transition guidance in paragraphs 21–28 of this FSP, its effect on the APBO should be accounted for as an actuarial experience gain pursuant to paragraphs 56 and 59 or 60 of Statement 106.

Effect of the Subsidy on Current Measures of Net Periodic Postretirement Benefit Cost

14. Because the subsidy affects the employer's share of its plan's costs, the subsidy is included in measuring the costs of benefits attributable to current service. Therefore, the subsidy reduces service cost (as defined in paragraph 47 of Statement 106) when it is recognized as a component of net periodic postretirement benefit cost.

Changes in Estimates

15. If an estimate of the expected subsidy subsequently changes—as a result of changes in regulations or legislation, changes in the underlying estimates of postretirement prescription drug costs, or for reasons other than a plan amendment—the effect of the

⁴ New Section 139A of the Internal Revenue Code established by Section 1202 of the Act.

change in estimate is an actuarial experience gain or loss pursuant to paragraph 56 of Statement 106.

Plan Amendments

16. If prescription drug benefits currently available under an existing plan are deemed *not* actuarially equivalent as of the date of enactment of the Act, but the plan is subsequently amended so as to provide actuarially equivalent benefits, the direct effect of the plan amendment on the APBO (that is, the effect of only the change in prescription drug coverage) and the effect on the APBO from any resulting subsidy to which the employer is expected to be entitled as a result of the amendment should be combined. If that combined effect reduces the APBO, it is deemed to be an actuarial experience gain pursuant to paragraph 56 of Statement 106. If the combined effect increases the APBO, it is deemed to be prior service cost that should be accounted for pursuant to paragraphs 50–54 of Statement 106.

17. A plan that provides prescription drug benefits that previously were deemed actuarially equivalent under the Act may be subsequently amended to reduce its prescription drug coverage and that reduced coverage may cease to be considered actuarially equivalent. In that circumstance, any actuarial experience gain related to the subsidy previously recognized is unaffected. However, the combined net effect on the APBO of (a) the subsequent plan amendment that reduces benefits under the plan and thus disqualifies the benefits as actuarially equivalent and (b) the elimination of the subsidy should be accounted for as prior service cost (credit) as of the date the amendment is adopted.

Income Tax Accounting

18. In the periods in which the subsidy affects the employer's accounting for the plan, it should have no effect on any plan-related temporary difference accounted for under Statement 109 because the subsidy is exempt from federal taxation. That is, the measure of any temporary difference should continue to be determined as if the subsidy did not exist. To illustrate, consider the following simple example.

Prior to the adoption of this FSP, an employer's carrying amount of accrued postretirement benefit cost (the amount recognized in the statement of financial position) is \$100 for a noncontributory, unfunded prescription drug benefit plan with only inactive participants who are not yet eligible to collect benefits. Assuming a tax rate of 35 percent and no corresponding tax basis for the accrued postretirement benefit cost, the employer would report a \$35 deferred tax asset related to that \$100 deductible temporary difference. Because the employer has a policy of amortizing gains and losses under paragraph 59 of Statement 106, upon adoption of the FSP and recognition of a \$28 actuarial gain resulting from the subsidy, neither the carrying amount of accrued postretirement benefit cost nor the deferred tax asset would change. Subsequently, ignoring interest on the APBO (which includes interest on the subsidy), as the actuarial gain related to the subsidy is amortized as a component of net periodic postretirement benefit cost, the carrying amount of accrued postretirement cost would be reduced. However, the associated temporary

difference and deferred tax asset would remain unchanged. That is, after the gain related to the subsidy is amortized in its entirety, the carrying amount of accrued postretirement benefit cost would be \$72, and the deferred tax asset would remain at \$35.

For purposes of simplicity, this example ignores complexities as to the amount and timing of the subsidies reflected in the carrying amount of accrued postretirement benefit cost arising from any of the following: (a) netting gains and losses and application of the corridor amortization approach described in paragraph 59 of Statement 106, (b) recognition of additional subsidies through amortization of prior service costs that include effects of the subsidy, or (c) reduction in future service and interest costs. Those complexities must be considered in determining the temporary difference on which the deferred tax effects under Statement 109 will be based. However, providing detailed guidance on the application of Statement 109 to postretirement benefits other than pensions is beyond the scope of this FSP.

Disclosures

19. Until an employer is able to determine whether benefits provided by its plan are actuarially equivalent, it should disclose the following in financial statements for interim or annual periods:

- a. The existence of the Act.
- b. The fact that measures of the APBO or net periodic postretirement benefit cost do not reflect any amount associated with the subsidy because the employer is unable to conclude whether the benefits provided by the plan are actuarially equivalent to Medicare Part D under the Act.

20. In interim and annual financial statements for the first period in which an employer includes the effects of the subsidy in measuring either net periodic postretirement benefit cost or the APBO or both, it should disclose the following:

- a. The reduction in the APBO for the subsidy related to benefits attributed to past service.
- b. The effect of the subsidy on the measurement of net periodic postretirement benefit cost for the current period. That effect includes (1) any amortization of the actuarial experience gain in (a) either explicitly or implicitly as a component of the net amortization called for by paragraph 59 of Statement 106, (2) the reduction in current period service cost due to the subsidy, and (3) the resulting reduction in interest cost on the APBO as a result of the subsidy.
- c. Any other disclosures required by paragraph 5(r) of Statement 132 (revised 2003). Paragraph 5(r) of that Statement requires disclosure of “an explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this Statement.”

Transition and Effective Date

21. This FSP supersedes FSP FAS 106-1. If an employer either (a) concludes that benefits available under its plan are not actuarially equivalent to Medicare Part D or (b) is unable to conclude (refer to paragraph 28) whether those benefits are actuarially equivalent, it should, subject to the guidance in the following sentence, recognize any effects of the Act other than the subsidy (for example, changes in estimated participation rates or health care costs) at the next measurement date for plan assets and obligations required by paragraphs 23–26 of this FSP. If the only effects of the Act are changes in participation rates or estimated health care costs, and those effects do not cause the employer to conclude that enactment of the Act is a “significant event” pursuant to paragraph 73 of Statement 106, those effects may be incorporated in the next regularly scheduled measurement of plan assets and obligations.

22. Notwithstanding the effective dates described in the following paragraphs, earlier application of this FSP is permitted in financial statements for any period including or following enactment of the Act that have not yet been issued as of the date of issuance of this FSP.

Employers That Elected Deferral

23. Except for certain nonpublic entities (refer to paragraph 25), this FSP is effective for the first interim or annual period beginning after June 15, 2004. When this FSP is initially applied, a remeasurement of the plan’s assets and APBO, including the effects of the subsidy, if applicable, as well as the other effects of the Act, should be made as of the earlier of (a) the plan’s measurement date that normally would have followed enactment of the Act or (b) the end of the employer’s interim or annual period that includes the date of the Act’s enactment. The measurement of the APBO should be based on the plan provisions in place on that measurement date. However, if the prescription drug coverage provided by a plan was amended after December 8, 2003, but before January 31, 2004 (the date before which plan amendments would not cause the deferral provided by FSP FAS 106-1 to expire), the effects of the prescription drug plan amendment and the consequential effects of the subsidy should be accounted for on a combined basis pursuant to the guidance in paragraph 16 of this FSP. Plan amendments occurring after the measurement date pursuant to (a) or (b) should not be anticipated in performing that measurement.

24. The effects of measuring plan assets and obligations under paragraph 23 generally will not affect the accrued or prepaid postretirement benefit cost reported in the employer’s statement of financial position as of the measurement date.⁵ However, those measurements will affect net periodic postretirement benefit cost for periods subsequent to the date of the remeasurement.⁶ To the extent that previously issued financial reports

⁵ The paragraph 23 measurement would affect the statement of financial position if, pursuant to paragraph 60 of Statement 106, the employer has a policy of immediately recognizing gains and losses.

⁶ Depending on the measurement date selected for the plan pursuant to paragraph 72 of Statement 106, the net periodic postretirement benefit cost may not be affected by the Act in the employer’s reporting period immediately following the measurement required by paragraph 23. For example, for a public company with a December 31 fiscal year-end, the end of the employer’s interim period that includes the date of enactment would be December 31, 2003. If that employer uses a September 30 measurement date pursuant

for periods prior to the effective date of this FSP would have been affected by the remeasurement of plan assets and obligations under paragraph 23, the requirements in paragraph 20 of APB Opinion No. 20, *Accounting Changes*, and paragraph 10 of FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, as applicable, should be followed.⁷ In calculating the effects on prior periods, the guidance in paragraphs 16 and 17 of this FSP applies to plan amendments adopted subsequent to the measurement date described in paragraph 23 but before the effective date of this FSP. The effects of any such amendment should be determined as of the date the plan amendment is adopted. The following examples illustrate the application of the provisions of this paragraph.

Example A—Calendar Year-End, September 30 Measurement Date

Calendar Company, a public company, sponsors a postretirement health care benefit plan that provides prescription drug coverage. It has a December 31 year-end for financial reporting purposes and uses a September 30 measurement date pursuant to paragraph 72 of Statement 106. Calendar Company elected to defer any accounting for the effects of the Act pursuant to FSP FAS 106-1 and made that election in the quarter ending March 31, 2004, the first period in which the plan's accounting for the effects of the Act normally would have been reflected in Calendar Company's financial statements.

Calendar Company adopts the guidance in this FSP as of July 1, 2004, the beginning of its third quarter. Calendar Company and its actuarial advisors determine that benefits provided by the plan are at least actuarially equivalent to Medicare Part D and, accordingly, Calendar Company will be entitled to the subsidy. Calendar Company measures the effects of the Act on the APBO as of December 31, 2003, the end of its interim (and annual) period that includes the date of the Act's enactment and determines that the aggregate effect on service cost, interest cost, and amortization of gains and losses results in a reduction of \$500 in annual net periodic postretirement benefit cost compared to that amount calculated without considering the effects of the Act.

The effect of applying this FSP has no cumulative effect on Calendar Company's retained earnings as of December 31, 2003. Because Calendar Company uses a September 30 measurement date, the accounting for the plan is reflected in Calendar Company's financial statements on a one-quarter lag. Therefore, the Act had no effect on net periodic postretirement benefit cost for the first quarter. Accordingly, in applying the guidance in Statement 3, Calendar Company reports net periodic postretirement benefit cost for the 9-month period ending September 30, 2004, reflecting \$250 (the second and third quarter amounts) of the \$500 annual reduction.

to paragraph 72 of Statement 106, the effects of the Act on the plan would first affect net periodic postretirement benefit cost in the employer's interim period that begins April 1, 2004.

⁷ Paragraph 10 of Statement 3 states that no cumulative effect of a change in accounting principle should be included in net income of the interim period, other than the first interim period, in which the change is adopted. However, financial information for the pre-change interim periods of the fiscal year in which the change is made shall be restated on the basis of the new accounting principle whenever those pre-change interim periods are subsequently presented.

Net periodic postretirement benefit cost included in third quarter results of operations reflects only that quarter's \$125 reduction due to the Act. When presented for comparative purposes, for example in summary quarterly financial information in the annual report or for comparative purposes in the 2005 second quarter financial report, the results of operations for the second quarter of 2004 will be restated to reflect a \$125 reduction in net periodic postretirement benefit cost due to the Act.

Example B—April 30 Year-End, April 30 Measurement Date

Spring Company, a public company, sponsors a postretirement health care benefit plan that provides prescription drug coverage. It has an April 30 year-end for financial reporting purposes and uses April 30 as the measurement date for plan assets and obligations under Statement 106. Spring Company elected to defer any accounting for the effects of the Act pursuant to FSP FAS 106-1 and made that election in the quarter ending January 31, 2004, the first period in which the plan's accounting for the effects of the Act normally would have been reflected in Spring Company's financial statements.

Spring Company adopts the guidance in this FSP as of August 1, 2004, the beginning of its second quarter. Spring Company and its actuarial advisors determine that benefits provided by the plan are at least actuarially equivalent to Medicare Part D and, accordingly, Spring Company will be entitled to the subsidy. Spring Company measures the effects of the Act on the APBO as of January 31, 2004, the end of its interim period that includes the date of the Act's enactment and determines that the aggregate effect on service cost, interest cost, and amortization of gains and losses results in a reduction of \$500 in annual net periodic postretirement benefit cost compared to that amount calculated without considering the effects of the Act.

Because the date for remeasuring the plan's assets and obligations required by this FSP occurs in Spring Company's prior fiscal year, the cumulative effect of applying the guidance in this FSP on Spring Company's retained earnings as of April 30, 2004, is \$125 (the fourth quarter effect on net periodic postretirement cost, ignoring any deferred income tax effects, which may be none). That cumulative effect of a change in accounting principle is recognized in Spring Company's net income for the 6 months ending October 31, 2004. Assuming no other changes in assumptions or other gains and losses arise in the regularly scheduled April 30, 2004 measurement of the plan, pursuant to the guidance in Statement 3, Spring Company reports net periodic postretirement benefit cost for the 6-month period ending October 31, 2004, reflecting \$250 (the first and second quarter amounts) of the \$500 annual reduction. Net periodic postretirement benefit cost included in second quarter results of operations reflects only that quarter's \$125 reduction due to the Act. When presented for comparative purposes, for example in summary quarterly financial information in the annual report or for comparative purposes in the next fiscal year's first quarter financial report, the results of operations for the quarter ended July 31, 2004, will be restated to reflect the \$125 reduction in net periodic

postretirement benefit cost due to the Act and the \$125 cumulative effect of the change in accounting principle.

25. A nonpublic entity, as defined in FASB Statement No. 87, *Employers' Accounting for Pensions*, that sponsors one or more defined benefit postretirement health care plans that provide prescription drug coverage but of which no plan has more than 100 participants may follow the guidance in paragraph 23, including the related transition guidance described in paragraph 24, or may incorporate the effects of the Act prospectively as of the next regularly scheduled measurement date for plan assets and obligations for fiscal years ending on or after September 15, 2004.

26. For an employer that elected the deferral provided by FSP FAS 106-1, but that deferral expired because of a subsequent event (for example, a plan amendment) prior to the issuance of this FSP, the effective date and transition shall be the same as for an employer that did not elect deferral (refer to paragraph 27).

Employers That Did Not Elect Deferral

27. For an employer that did not elect the deferral option provided under FSP FAS 106-1 and whose previous accounting for the effects of the Act differs from the guidance in this FSP, this FSP is effective for financial statements for interim or annual periods beginning after June 15, 2004. For that employer, the adoption of this FSP constitutes a change in accounting principle under Opinion 20. Accordingly, the cumulative effect of retroactive application of this FSP to the date of the Act's enactment should be reflected in the financial statements following the provisions of paragraph 20 of Opinion 20 and paragraphs 9 and 10 of Statement 3, as applicable.

Subsequent Determination of Actuarial Equivalence Absent a Plan Amendment

28. When initially applying this FSP, an employer and its actuarial consultants may be unable to determine whether the benefits provided by a plan are actuarially equivalent as of the date of the initial measurement applying the guidance in this FSP. If clarifying regulations related to the Act or new information about the interpretation or determination of *actuarial equivalency* under the Act becomes available, the employer should reconsider whether the benefits provided under its plan, as presently constructed, are actuarially equivalent.⁸ If that reconsideration results in a conclusion that benefits provided by the plan are actuarially equivalent, that conclusion could be a significant event pursuant to paragraph 73 of Statement 106. If that is the case—that is, if the effects of the subsidy on the plan are likely to be significant—a measurement of plan assets and obligations should be performed as of the date that actuarial equivalency is determined. Measures of net periodic postretirement benefit cost for subsequent periods would reflect the effects of those measurements (reported on a lag basis, if appropriate; refer to footnote 6). Prior financial statements should not be retroactively adjusted nor should a cumulative effect for prior periods be recognized in income.

⁸ If that reconsideration is the result of a plan amendment, the guidance in paragraphs 16 and 17 of this FSP should be applied as of the date of the amendment.