

FASB Responds to Medicare Legislation

On December 8, 2003, the President signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (“the Act”). The Act introduces a prescription drug benefit for Medicare-eligible individuals, referred to as Medicare Part D, and offers a subsidy to sponsors of employment-based prescription drug coverage. Because of the unique accounting issues raised by the subsidy, the Board provided an elective deferral of the accounting for the effects of the Act in FSP FAS 106-1, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*. Presently, the Board is in the process of considering those issues with the expectation of publishing definitive guidance during the first half of 2004.

Existing GAAP Requires Consideration of Medicare

FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions*, contains guidance for employers that provide postretirement healthcare benefits for their retirees. In general, Statement 106 requires that employers recognize the cost of healthcare benefits to be provided to their retirees in the future as those individuals render services as employees. A key element of the cost of those benefits is coverage available to retirees under Medicare. Because the Act introduces, for the first time, a prescription drug feature to Medicare as well as an unprecedented subsidy to plan sponsors, a number of constituents raised questions regarding the appropriate accounting for the effects of the Act. Compounding the constituents' dilemma were the timing of enactment—late in 2003, close to the financial reporting year-end for the majority of business enterprises—and the numerous uncertainties regarding the intent and operation of the Act's provisions, particularly those provisions related to the available plan sponsor subsidy.

How to Account for the Subsidy

The subsidy to plan sponsors is based on 28% of qualifying retiree prescription drug costs incurred during a year in excess of \$250 up to a maximum of \$5,000. Statement 106, as written, understandably did not contemplate the possibility of a government subsidy to plan sponsors as a means of defraying their costs of providing retiree healthcare coverage. Therefore, it is unclear whether such an event should be accounted for within the context of Statement 106 or whether it should be recognized as a separate economic event outside of the retiree healthcare context. Unfortunately, U.S. GAAP, in general, let alone Statement 106, contains relatively sparse guidance on the accounting for subsidies.

Some believe that the subsidy is just another form of Medicare coverage that is already contemplated in Statement 106. Others believe that the subsidy is sufficiently different from other aspects of Medicare to warrant different accounting treatment. In particular, the subsidy is payable directly to plan sponsors (rather than participants), and is non-taxable to the sponsor even though the underlying healthcare costs remain fully deductible for tax purposes.

Time Is of the Essence

Because of the significantly different financial reporting that would result, depending on whether or not the subsidy is viewed in a Statement 106 context, careful deliberation and due process were imperative. The Board needed additional time to properly consider all of the relevant arguments. Unfortunately, the end of 2003 and the peak financial reporting season was imminent, therefore, time also was of the essence. That is because accounting standards, in general, and Statement 106, in particular, require the effects of enacted legislation to be considered in financial reports covering the period of enactment.

The FASB needed to react quickly without sacrificing the careful deliberation and due process that our constituents expect and our mission requires. Recognizing that it would be impossible for the Board to meaningfully debate the accounting issues raised by the Act and conclude those discussions in time for constituents to consider any ensuing guidance in preparing 2003 year-end financial reports, the Board directed the staff to issue a draft FASB Staff Position (FSP) that would require companies to defer any accounting for the effects of the Act until the Board has an opportunity to consider the questions raised by the Act and issue appropriate guidance.

The Board weighed that decision carefully because the passage of laws and regulations *are* economic events that generally warrant accounting recognition in the period in which they become law. However, on balance, because of the unresolved accounting questions, the uncertainties surrounding this particular piece of legislation, and the fact that many of the Act's provisions will not take effect until 2006, the Board concluded that deferral was the appropriate option.

Interim Guidance Issued

The draft FSP recommending a complete deferral of the accounting for the effects of the Act was issued on December 11, 2003, and the Board received 14 comment letters. Based on those comments from constituents, many of who believe (i) that the Act should be accounted for in the period of enactment and (ii) that preparers of financial statements frequently are required to account for transactions for which the accounting guidance is

unclear, the Board decided that the deferral should be elective—that is, companies could either defer accounting for the effects of the Act or attempt to interpret existing GAAP with respect to the Act and account for its effects in 2003. That interim guidance is contained in FSP FAS 106-1, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, which also contains additional disclosure and transitional considerations. FSP FAS 106-1 was issued on January 12, 2004.

Recent Developments

Having issued the FSP, the Board and staff set out to address the accounting issues related to the subsidy as quickly as possible:

- The accounting for the subsidy, related to benefits previously accrued
- The effect of the subsidy on the cost of benefits for future employee service
- The interaction of plan amendments in response to the Act with the effect of the subsidy
- Consequential income tax accounting considerations arising from the non-taxable nature of the subsidy.

In order to resolve those issues, the first question that needed to be addressed was whether the subsidy to plan sponsors should be accounted for within the context of Statement 106, as that bears significantly on the available recognition and measurement alternatives. At its meeting on February 11, 2004, the Board decided that it was appropriate to account for all of the effects of the Act within the Statement 106 context, including the effects of the federal subsidy.

The Basic Issues

At its meeting on February 18, 2004, the Board began consideration of the specific accounting issues in the context of Statement 106, the principal issue being the accounting for the effect of the subsidy on the cost of benefits previously accrued. The Board considered whether the subsidy should be reflected as:

- *Actuarial gain*: measured as of the date of enactment, initially deferred and amortized together with other unrecognized gains and losses of the plan
- *Negative plan amendment*: measured as of the date of enactment, initially deferred and amortized over the average remaining service period of the affected employee group
- *Special subsidy from the government*: measured as of the date of enactment and recognized immediately in income.

That third alternative is not specifically addressed in Statement 106 but was identified by analogy to EITF Issue No. 03-2, “Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities.” The staff presented the various pros and cons for each of those alternatives and, ultimately, the Board concluded that the subsidy essentially represents a reduction to the cost of benefits provided as a result of an increase in the available Medicare benefit; therefore, the subsidy should be treated like other changes in the level or extent of Medicare coverage—as an actuarial gain. However, the Board also noted that no accounting for the subsidy should occur until a plan sponsor determines that a plan is actuarially equivalent, a determination that may be inconclusive for some plans until final regulations are issued.

Having resolved that threshold question, the Board then decided that the effect of the subsidy on the cost of benefits for future employee service should reduce that cost currently as the costs are accrued. Any future changes in those expected subsidies would also be treated as actuarial experience changes subject to the deferral and amortization provisions of Statement 106.

Plan Amendments

With respect to the interaction of plan amendments with the effects of the subsidy, the Board distinguished between plan amendments that have the result of making the sponsor eligible for the subsidy (qualifying amendments) and amendments that have the result of making a previously eligible sponsor ineligible for the subsidy (disqualifying amendments). For qualifying amendments, the direct effect of the amendment should be combined with the effect of the subsidy in a single measure of the plan amendment. If the net result is a decrease in the obligation, that net effect should be considered an actuarial gain (similar to the accounting for the retroactive effects of the subsidy). If the net result is an increase in the obligation, that net effect should be considered prior service cost (the standard treatment of plan amendments in Statement 106). For disqualifying amendments, the plan amendment would be considered a separate event unrelated to the initial recognition of the subsidy and should be accounted for like all other (negative) plan amendments.

Income Taxes

Because the subsidy is exempt from federal income tax, the Board concluded that the existing deferred tax asset related to the postretirement healthcare liability should not be affected by the reduction in that obligation attributable to the subsidy. Under that approach, whenever subsidies are recognized—either upon enactment or subsequently—the net benefit to results of operations will be recognized as a tax-free benefit.

Transition and Effective Date

The Board concluded its deliberations on February 25, 2004, with a discussion of the method by which plan sponsors should adopt the proposed guidance as well as a consideration of relevant disclosures related to the subsidy and adoption of the proposed guidance. Although those transition and disclosure provisions will depend on the specific circumstances of individual plans and plan sponsors, in general the Board decided that the proposed guidance should be effective for interim or annual periods beginning after June 15, 2004, with the effects of the subsidy measured as of the end of the first interim or annual period ending after the date of enactment. For a calendar-year company with an actuarially equivalent plan, the proposed guidance would be adopted in the third quarter of 2004 with 2004 full-year expense based on the measurement of the effect of the subsidy as of December 31, 2003. The Board also provided some relief for nonpublic companies that sponsor only small plans (plans with less than 100 participants) by permitting those companies to adopt the guidance prospectively as of the next regularly scheduled measurement date for their postretirement healthcare benefit plan(s) for years ending after September 15, 2004.

As this article goes to press, the staff is in the process of drafting another FASB Staff Position fully describing the proposed guidance, which it expects to issue for public comment during the first half of March.

Stay tuned.