

April 12, 2004

Letter of Comment No: 7
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Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed FASB Staff Position No. FAS 106-b, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*

Dear Mr. Smith:

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the proposed FASB Staff Position (the "Proposed FSP"), *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*. We have the following comments and observations for your consideration.

We agree with the conclusion in the Proposed FSP that the employer subsidy related to prescription drug benefits provided by the new Medicare legislation should be accounted for under FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, consistent with the guidance in paragraphs 35 and 40 of that Statement. In addition, we agree that the reduction in the accumulated postretirement benefit obligation (APBO) for the expected effects of the legislation – including both the expected subsidy and other effects of the Act due to assumed changes in per capita claims costs and other assumptions – should be accounted for as an actuarial gain under FAS 106.

We disagree with certain aspects of the Proposed FSP, as discussed below. We also offer some recommendations to improve the FSP's clarity and understandability.

Transition

Paragraph 24 of the Proposed FSP provides that to the extent previously issued financial statements for periods prior to the effective date of the FSP would have been affected by the remeasurement of plan assets and obligations under paragraph 23, those earlier periods would need to be restated when subsequently presented. The Proposed FSP refers to APB 20, *Accounting Changes*, and FAS 3, *Reporting Accounting Changes in Interim Financial Statements*. However, paragraph 8 of APB 20 states:

. . . neither (a) initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect nor (b) adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring is a change in accounting principle.

Unlike the employer addressed by paragraph 27 of the Proposed FSP, who has been accounting for the effects of the legislation, employers that elected the deferral option authorized by FSP FAS 106-1, *Accounting and Disclosure Requirements Related to the New Medicare Prescription Drug, Improvement and Modernization Act of 2003*, have not accounted for the effects of the legislation yet. Therefore, we believe their first-time accounting for the effects of the legislation, particularly the subsidy, would fall under paragraph 8 of APB 20 and would not be the type of event contemplated by APB 20 for restatement. Further, employers in those situations would not be correcting an error in their financial statements. Thus, we believe it would be inconsistent with APB 20 to refer to the initial accounting for the effects of the legislation as an accounting change that is subject to the guidance in FAS 3. Accordingly, we recommend that the staff reconsider the reference to FAS 3 and the proposed requirement to restate prior quarters' financial statements (even if such restatements are required only when the statements are issued for comparative purposes).

We encourage the staff to take a practical approach to transition, consistent with the conclusions in FAS 106, paragraph 250, which states, in part:

. . . transition is, to a significant extent, a practical matter. A major objective of transition is to minimize implementation costs and to mitigate disruption to the extent possible without unduly compromising the ability of financial statements to provide useful information.

Accordingly, for employers that elected the deferral option under FSP FAS 106-1, we recommend the following approach, which we believe would be consistent with the spirit of paragraph 250:

- At the date when actuarial equivalence is determined – either the enactment date or subsequent to the enactment date – the employer should determine whether the effect of the legislation on the APBO and expense is significant.
- If the effect is not significant, the employer should incorporate the effects of the legislation when it remeasures the APBO at its next regular measurement date.

- If the effect is significant, the employer should remeasure the APBO at the end of its interim or annual period that includes the enactment date. The effect of the remeasurement should be reported solely in the interim period in which the remeasurement takes place. For example, for a calendar year-end employer with a December 31 measurement date that in the third quarter of 2004 remeasures its APBO as of January 1, 2004, the effect of the remeasurement would be reflected in the third quarter of 2004 with no restatement of previous quarters. This approach is consistent with the annual true-up process currently utilized by many employers. Under that process, employers estimate at the beginning of the year what their FAS 106 expense for the year will be, pending the completion of their beginning-of-the-year actuarial valuations. Expense for, say, the first quarter would be reported based on a proration of the initial estimate. When the valuation is completed in the second quarter, expense for the six-months ended June 30 (for a calendar year employer) would then be true-up in the second quarter based on the completed valuation. However, the prior quarter's financial statements would not be restated.

We also believe the guidance in paragraph 21 of the Proposed FSP is inconsistent with the guidance in paragraph 23. Paragraph 21 provides that if the only effects of the Medicare legislation are changes in participation rates or estimated health care costs and those effects do not cause the employer to conclude that the enactment of the legislation is a "significant event," then the effects of the legislation may be incorporated in the next regularly scheduled measurement of plan assets and obligations. Presumably this means that if the next regular measurement is December 31, 2004, that is the measurement in which the effects would be incorporated. However, paragraph 23, which applies to employers that elected to defer accounting for the legislation under FSP FAS 106-1, does not provide for similar deferred recognition, even if the employer concludes that the enactment of the legislation does not constitute a "significant event" for its plan. The difference between these two paragraphs is that paragraph 23 includes the effects of the subsidy while paragraph 21 does not. We believe that the fact that the employer will be entitled to a subsidy, irrespective of its materiality, should not result in different provisions and that paragraph 23 should also include a deferral provision for employers for whom the enactment of the legislation is not considered to be a significant event calling for an interim measurement.

Scope

Paragraph 3 indicates that the guidance in the FSP on accounting for the subsidy would apply only when "the employer has concluded that prescription drug benefits available under the plan are 'actuarially equivalent' and thus qualify for the subsidy under the Act." We recommend that this paragraph be clarified to reflect that employers will consider whether benefits are actuarially equivalent "for some or all future years" based on the terms of the substantive plan. We have encountered many plans where it is possible to assert that the benefit will be actuarially equivalent for some but not all future years because of, for example, caps on the level of employer-provided benefits or other cost-sharing provisions. Accordingly, our recommended clarification would ensure that the Proposed FSP will also cover plans that

employers have concluded are actuarially equivalent for some but not all future years. We also suggest that this clarification (i.e., for some or all future years) be included in paragraph 28 wherever reference is made to benefits that are actuarially equivalent. Paragraph 28 also should be expanded to cover situations in which the employer decides that benefits are not equivalent, in addition to situations in which the employer is unable to make that determination.

Plan Amendments

Under the Proposed FSP, if a plan is amended to provide actuarially equivalent benefits, the combined effect of the plan amendment and the subsidy is treated as an actuarial gain if the APBO decreases and as a plan amendment if the APBO increases. We cannot think of an instance under FAS 106 where the direction of change in the APBO dictates how the change should be accounted for. To be consistent with the guidance in FAS 106, we recommend that the FSP require the same accounting for the effects of the subsidy, regardless of whether an employer amended its plan to create an actuarially equivalent benefit. Accordingly, all changes in the obligation due to the subsidy, whether or not attributable to a plan amendment, should be accounted for as an actuarial gain (or loss in the scenario addressed in paragraph 17), and the impact of any plan amendment necessary for the employer to be entitled to the subsidy (or that reduces drug coverage such that benefits cease to be actuarially equivalent) should be accounted for consistent with paragraphs 50-55 of FAS 106.

Our recommendation above would help to prevent certain counterintuitive results. For example, an employer, whose benefit was actuarially equivalent at the date of enactment but elected to defer accounting for the effects of the legislation as permitted by FSP FAS 106-1, may have amended its plan in January 2004 to make its postretirement drug coverage secondary to coverage under Medicare. The plan amendment causes the plan to no longer be actuarially equivalent. Under paragraph 23 of the Proposed FSP, it appears that upon initial adoption of the FSP the employer must first record an actuarial gain for the effects of the subsidy that it was entitled to receive. Then, under paragraph 17, it must record negative prior service cost for the combined net effect of the amendment on the APBO, i.e., the effect of lower expected per capita claims cost resulting from the reduced coverage (which decreases the APBO and is deemed to be a negative plan amendment under the Proposed FSP) less the effects of losing the ability to receive a subsidy (which increases the APBO and we believe would be an actuarial loss under the Proposed FSP). We believe the effect of losing the subsidy (an actuarial loss) should be applied against any remaining unrecognized actuarial gain related to the subsidy that arose when first applying the FSP. In our view, that is more consistent with FAS 106 than an approach whereby the loss of the subsidy is aggregated with the negative plan amendment and reduces the amortization of negative prior service cost. We note that if these events were accounted for under paragraph 16, the decrease in the APBO would be accounted for as an actuarial gain rather than a negative plan amendment. We see no rational basis to account for similar events and transactions differently between the two paragraphs. Changes in the APBO due to the subsidy should be accounted for as an actuarial gain or loss. Changes in the APBO due to positive or negative plan amendments should be accounted for in accordance with paragraphs 50-55 of FAS 106.

Income Taxes

We believe employers could incur significant costs to segregate the effects of the tax-free subsidy on the service, interest, and amortization components of net periodic benefit cost to determine, for example, the portion of the amortization of gain/loss that relates to the permanent versus temporary difference. It would seem that most employers will need to perform two separate actuarial valuations of their postretirement benefit obligations annually and whenever interim measurements are performed – one valuation would include the effects of the subsidy and one would exclude it. We encourage the staff to explore possible approaches to addressing the effects of the subsidy on the accounting for income taxes to enable employers to avoid the cost of separate actuarial valuations performed with and without the effects of the subsidy and to otherwise make it simpler to comply with the requirements of FAS 109, *Accounting for Income Taxes*. For example, the FSP might recognize that employers could choose a convention (e.g., first-in, first-out or pro rata) that is appropriate in their circumstances to determine which gain/loss reverses first.

Disclosures

Paragraph 20 of the Proposed FSP would require certain disclosures for interim and annual financial statements for the first period in which an employer includes the effects of the subsidy in either the measurement of net periodic postretirement benefit cost or the APBO or both. The proposed disclosures exceed the disclosure requirements of FAS 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106* (FAS 132R). In particular, for interim reporting we do not read FAS 132R to require any information about significant events occurring during interim periods – including the effect of an interim remeasurement related to a significant plan amendment, curtailment or settlement – other than the amounts reflected in the components of expense reported for the period. Thus, we believe that the Proposed FSP's requirement to comply with paragraph 5(r) for interim purposes would constitute an amendment of that Statement. Such an amendment would not, in our view, be a "narrow and limited revision" for which FSPs can be used, even if Board-directed. Accordingly, we recommend that the proposed disclosures be reconsidered. Any disclosures that go beyond what is required by FAS 132R can be encouraged but should not be required.

Effective Date

The Proposed FSP would be effective for the first interim or annual period beginning after June 15, 2004. If the FSP is adopted with the proposed transition rules, many employers would require special actuarial valuations to be performed by the end of the third quarter of 2004. That requirement may not provide adequate time for employers to study proposed regulations defining actuarial equivalency, which are expected to be out by summer. As such, we recommend that the FSP be effective for the period beginning after September 15, 2004 with earlier application encouraged.



We also find the Proposed FSP's transition rules hard to follow and recommend that the staff add a chart to the FSP that summarizes those rules. Exhibit 1 attached to this letter summarizes what we believe the Proposed FSP currently requires for employers that elected deferral under FSP FAS 106-1. Exhibit 2 summarizes the changes we would propose based on the views we have expressed herein.

* * *

We appreciate the opportunity to express our views on the proposal. If you have any questions regarding our comments, please contact Ken Dakdduk (973-236-7239) or Diane Howell (973-236-5819).

Sincerely,

PricewaterhouseCoopers LLP

EXHIBIT 1 – Transition Rules for Employers that Elected Deferral Under FSP FAS 106-1 under the Proposed FSP

Situation	Proposed Accounting	Proposed Transition	Possible Restatement
Plan is actuarially equivalent as of the enactment date	Actuarial experience gain for the effect of the subsidy	During first interim or annual period beginning after June 15, 2004, full plan remeasurement as of the earlier of the plan's next regular measurement date that follows the enactment date or the end of the employer's interim or annual period that includes the enactment date	Earlier quarters may need to be restated in accordance with FAS 3 if effect on net periodic benefit cost in those quarters is material
Plan does not meet actuarial equivalence as of the enactment date	No accounting for subsidy but may need to remeasure APBO for other effects of the Act, creating an actuarial gain/loss	During first interim or annual period beginning after June 15, 2004, full plan remeasurement as of the earlier of the plan's next regular measurement date that follows the enactment date or, if the enactment of the Act is considered a significant event (as described in paragraph 73 of FAS 106), at the end of the employer's interim or annual period that includes the enactment date	Earlier quarters may need to be restated in accordance with FAS 3 if effect on net periodic benefit cost in those quarters is material
Plan at enactment date is not actuarially equivalent but is subsequently amended to be actuarially equivalent	If combined effect of subsidy and amendment increases the APBO, account for as prior service cost. If combined effect decreases APBO, account for as actuarial gain.	Account for combined effect on the date the amendment is adopted with prospective recognition	None
Unclear as to whether plan meets actuarial equivalence as of the enactment date	Actuarial gain if subsequently determined that plan is actuarially equivalent due to clarifying event (absent a plan amendment)	Remeasurement of APBO in period that clarifying event takes place (e.g., regulatory guidance) if a significant event; otherwise remeasure at next regular measurement date. Accounting prospective from remeasurement date	None
Estimate subsequently changes as to either (a) the plan's actuarial equivalence, or (b) the amount of the subsidy, for reasons not due to a plan amendment	Actuarial gain or loss	Remeasurement of APBO if clarifying event takes place (e.g., regulatory guidance) if a significant event; if not, measurement at next regular measurement date. Accounting prospective from remeasurement date	None

EXHIBIT 2 – Proposed Revised Transition Rules for Employers that Elected Deferral Under FSP FAS 106-1 (marked to show differences)

Situation	Proposed Accounting	Proposed Transition	Possible Restatement
Plan is actuarially equivalent as of the enactment date	Actuarial experience gain for the effect of the subsidy	During first interim or annual period beginning after June <u>September</u> 15, 2004, full plan remeasurement as of the earlier of the plan's next regular measurement date that follows the enactment date or the end of the employer's interim or annual period that includes the enactment date , <u>or, if the enactment of the Act is considered a significant event (as described in paragraph 73 of FAS 106), at the end of the employer's interim or annual period that includes the enactment date</u>	Earlier quarters may need to be restated in accordance with FAS 3 if effect on net periodic benefit cost in these quarters is material
Plan does not meet actuarial equivalence as of the enactment date	No accounting for subsidy but may need to remeasure APBO for other effects of the Act, creating an actuarial gain/loss	During first interim or annual period beginning after June <u>September</u> 15, 2004, full plan remeasurement as of the earlier of the plan's next regular measurement date that follows the enactment date or, if the enactment of the Act is considered a significant event (as described in paragraph 73 of FAS 106), at the end of the employer's interim or annual period that includes the enactment date	Earlier quarters may need to be restated in accordance with FAS 3 if effect on net periodic benefit cost in these quarters is material
Plan at enactment date is not actuarially equivalent but is subsequently amended to be actuarially equivalent	If combined effect of subsidy and amendment increases the APBO, account for as prior service cost. If combined effect decreases APBO, account for as actuarial gain. The effect of the subsidy is an actuarial gain; the effect of the amendment is accounted for as prior service cost	Account for combined effect on the date the amendment is adopted with prospective recognition. Full plan remeasurement as of the earlier of the plan's next regular measurement date that follows the enactment date or, if the enactment of the Act is considered a significant event (as described in paragraph 73 of FAS 106), at the end of the employer's interim or annual period that includes the enactment date	None
Unclear as to whether plan meets actuarial equivalence as of the enactment date	Actuarial gain if subsequently determined that plan is actuarially equivalent due to clarifying event	Remeasurement of APBO in period that clarifying event takes place (e.g., regulatory guidance) if a significant event; otherwise remeasure at next regular measurement date. Accounting prospective from remeasurement date	None
Estimate subsequently changes as to either (a) the plan's actuarial equivalence, or (b) the amount of the subsidy, for reasons not due to a plan amendment	Actuarial gain or loss	Remeasurement of APBO if clarifying event takes place (e.g., regulatory guidance) if a significant event; if not, measurement at next regular measurement date. Accounting prospective from remeasurement date	None