

Letter of Comment No: 5
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April 12, 2004

Mr. Lawrence W. Smith
Director—Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Dear Mr. Smith:

Re: Proposed FASB Staff Position No. FAS 106-b

We appreciate the opportunity to comment on the proposed FSP FAS 106-b, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*. Our observations and concerns are described below.

Definition of “Employer’s Share of the Costs [of Providing the Benefits]”

Paragraph 3 of the proposed FSP says that the FSP would apply only when the employer has concluded its “prescription drug benefits are ... actuarially equivalent [to Medicare Part D ... and ... the expected subsidy will offset or reduce the *employer’s share of the costs* of postretirement prescription drug coverage provided by the plan.” [Emphasis added.] It goes on to state that the FSP does not address accounting for the subsidy when “the expected subsidy exceeds the *employer’s share of the costs of [providing]* postretirement prescription drug coverage.” [Emphasis added.] We have a number of concerns with this guidance.

- 1. For many plans, the employer’s share of the prescription drug costs is not defined.** Many employers provide retiree medical and prescription drug benefits through the same plan, so the medical and drug benefits are subject to common cost-sharing provisions, such as retiree contributions, deductibles, out-of-pocket limits, and caps on the employer’s share of the plan’s cost. In those situations, it is not possible to determine the employer’s share of the cost of providing *just* the prescription drug benefits under the plan, without an arbitrary allocation of the retirees’ cost-sharing. Consequently, guidance is needed on how the Board intends ‘the employer’s share of the cost’ be determined in those situations.

- 2. Guidance is needed on whether or not an employer must compare its cost to each individual subsidy payment, or if the comparison of the employer's cost to the subsidy is to be made on some other basis.** It is logical to expect many situations in which the subsidy payment for a given claim will exceed the employer's share of the cost for that specific claim.
- Actuarial equivalence is expected to be based on a measurement of the average expected cost for a "plan" (not yet defined by HHS), versus the average value of Medicare prescription drug benefits. It is not clear whether the average expected cost of the plan will be measured considering total costs, or only the employer's share of those costs.
 - Even if the determination of "actuarial equivalence" is based on the employer's share of the average expected cost, there is no reason to believe that the employer's share of the cost will exceed the subsidy for each individual claim just because the average cost was determined to exceed the average value of the Medicare Part D benefit.
 - The definition of a "plan" to be used by HHS when determining actuarial equivalence is likely to be different than the definition of the "plan" under FAS 106.
 - Although actuarial equivalence is likely to be based on the employer's share of the cost, the subsidy payment itself is based on the gross cost of benefits paid by the plan, that is, the expenditures incurred by both the employer and the retirees.

If the FSP applies only to claims for which the employer's share of the cost exceeds the subsidy, there will be a significant burden on the employer to make such comparisons and many situations in which the FSP does not apply. If the comparison is not made on a claim-by-claim basis, then FASB must provide guidance on how it is to be made.

Subsidies Shared With Retirees

In discussions, the staff has indicated that the FSP effectively presumes the federal subsidy belongs to the employer, and that any sharing of the subsidy with plan participants is to be accounted for as a benefit improvement. However, that guidance is not provided in the proposed FSP, and is not necessarily intuitive to the reader.

Many employers may share a portion of the subsidy with retirees. In fact, in some cases it may be determined that, under the terms of the plan, the company has a legal obligation to share a portion of the subsidy with retirees. In that case, it would seem to be inconsistent with the notion of the substantive plan to account for the subsidy passed on to retirees as a plan amendment, when no amendment to the plan or communication with participants is needed. In particular, the staff's verbal guidance is troublesome when, based on the cost-sharing provisions of the plan, communication would be required if the company were *not* sharing the subsidy.

We would encourage the staff to reconsider its verbal guidance, particularly when the plan terms require a specified sharing of plan costs. Regardless of the ultimate decision on accounting for the portion of the subsidy to be shared with retirees through the plan's cost-sharing provisions, the FSP should be clear on the accounting treatment.

Plan Amendments After December 8

If an employer cannot determine actuarial equivalence at the transition date, the subsidy is to be measured and recognized prospectively from the date the determination can be made. However, footnote 8 to paragraph 28 says that if the determination is affected by a plan amendment that occurred subsequent to December 8, 2003, the effect of the amendment (determined in accordance with paragraphs 16 and 17 of the FSP) should be recognized as of the date of the amendment. The implications of that guidance on the timing of recognizing the effect of the subsidy are unclear when the plan amendment occurs prior to the time at which an employer can determine eligibility for the subsidy.

For example, let's say that at the transition date an employer cannot determine whether its benefits were actuarially equivalent to Medicare Part D. On August 1, 2004, the company amends its plan to improve benefits; the APBO is increased \$50 million. On November 1, 2004, HHS issues guidance on how actuarial equivalence is to be determined; the company determines that its benefits [at November 1, 2004] are actuarially equivalent to Medicare Part D, and the benefits will qualify for the subsidy. However, they also determine that the company would not have qualified for the subsidy if the benefits had not been improved. The effect of the subsidy, measured at November 1, resulted in a \$200 million reduction in the APBO. (At August 1 the subsidy would have reduced the APBO by \$195 million.) When and how does the company reflect the effect of the subsidy? Is the \$145 net reduction in the APBO recognized as an actuarial gain retroactive to August 1? Is the unamortized prior service cost at November 1 netted against the \$200 million actuarial gain from the subsidy? What if actuarial equivalence could not be determined until mid-2005?

Transition

Paragraph 21 of the proposed FSP indicates that, at the transition date, an employer should determine whether the benefits provided under its plan are actuarially equivalent to Medicare Part D. However, a question arises about whether one must look to the benefits under the plan as a whole or by groups of participants with common benefits and cost-sharing arrangements. Many plans entitle participants to the same benefits but with different cost sharing arrangements depending on when the participant retired and/or the number of years of service rendered at retirement. As a result, the assessment of actuarial equivalence will differ for each group. For example, one group may have little or no cost sharing, and the benefits are clearly actuarially equivalent to Medicare Part D. The benefits for a second group in the plan may be capped, and there is not enough information available currently to determine whether the benefits will be

considered to be actuarially equivalent to Medicare Part D. And the benefits for a third group in the plan may be retiree-pay-all, which would not be actuarially equivalent.

The proposed FSP does not indicate whether the effects of the Act should be measured and recognized on a group-by-group basis or delayed until a determination is made for all groups encompassed by the accounting for the plan. Normally, FAS 106 would seem to require assessing the effects on the plan as a whole. However, we believe that is not workable in this situation, and that the effects of the Act should be accounted for separately for each group, as determinations of actuarial equivalence can be made. We believe delaying recognition of the effect of the subsidy until actuarial equivalence could be determined for all participant groups covered by the plan would be inconsistent with accrual accounting based on the current best estimate of the cost of providing benefits under the plan.

Measurement of Deferred Tax Asset

It appears that determination of the deferred tax asset will require measurement of the net periodic cost and accrued postretirement benefit cost with and without the effects of the subsidy. From a valuation perspective, we have not been able to identify a reasonable approach to making this determination without effectively performing parallel valuations – as though there were two identical plans, one with the subsidy and the other without the subsidy. We estimate these parallel valuations could increase the valuation cost by 35% - 50%.

Other Comments

If, at the transition date, an employer is unable to conclude whether the benefits it is providing are actuarially equivalent to Medicare Part D, the company is to account for the subsidy when it can make a determination about actuarial equivalence. The other effects of the Act, such as changes in the company's assumed participation rate, are to be recognized at the transition date. We would observe, however, that in many situations the assumed participation rate will be influenced by whether the plan is considered to be actuarially equivalent to Medicare Part D. In these situations, decoupling the accounting for the subsidy and the other effects of the Act may be somewhat over-engineered.

We would also observe that the Medicare Modernization Act also may have implications on employers' FAS 112 accounting for disability plans. The Board may wish to indicate how the FSP would apply to accounting for the subsidy under both the FAS 43 and the FAS 5 approaches.

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We appreciate the opportunity to comment and would be pleased to discuss our comments and concerns with you further, if you so desire.

Sincerely yours,

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