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> Letter of Comment No: /S File Reference: FSPFAS106B

April 12, 2004

Director, TA&I—FSP Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Subject:

Proposed FASB Staff Position No. FAS 106-b

Mercer Human Resource Consulting is pleased to present our comments on Proposed FASB Staff Position No. FAS 106-b, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003. As the largest global actuarial firm, Mercer helps employers and other plan sponsors with the design, funding, delivery of, and accounting for their postretirement healthcare benefits. We are significant providers, consumers, and interpreters of information in the FAS 106 footnote. We support the Board's continuing efforts to provide financial statement users with consistent, meaningful, relevant and useful information and we applaud the Board's quick action in providing this essential guidance on accounting for the federal subsidy payable to single-employer plan sponsors under the Act.

Summary

We are in general agreement with the proposed accounting recognition for the federal subsidy. However, we are concerned that the proposed accounting treatment is unnecessarily complex and burdensome for employers that promptly amend their plans in response to the Act. We feel the final FASB Staff Position (FSP) should permit employers that amend their plans before the FSP's effective date to account for the net change in the employer's obligations using a simplified approach described below, whether the employer promptly reflected the effect of the subsidy or elected to defer recognition. The driving force behind our recommendation is our belief that an employer who ultimately commits to lower retiree benefits in the future should have a lower expense for the course that has been selected.

In addition, we believe additional guidance or clarification is needed with respect to certain other employer accounting and disclosure issues related to the Act. The final section of our comment letter poses a series of questions and Mercer's proposed answers. We request that the Board expand the final FSP to provide guidance on these additional issues.

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Simplified accounting for plans amended to be secondary to Medicare Part D

We believe that many plan sponsors will amend their plans in some fashion in direct response to the Act. Some sponsors whose plans are not currently actuarially equivalent to Medicare Part D will improve benefits to qualify for the federal subsidy. Some sponsors will amend their plans to share with their retirees a portion of the federal subsidy or reduction in costs from coordination with Medicare Part D, for example by reducing retiree contributions or modifying other cost sharing features. And nearly all sponsors that decide to provide retiree prescription drug benefits that will be secondary to Medicare Part D will have to amend their plans because, prior to the enactment date, few retiree health plans contained sufficiently broad coordination-of-benefits language that they would automatically coordinate with Medicare Part D upon enactment.

Under the proposed FSP, an employer's accounting for an amended plan is complex:

- The employer must first determine whether the plan would have been actuarially equivalent to Medicare Part D under its terms on the remeasurement date specified in paragraph 23.
- If the employer determines that the plan would have been actuarially equivalent on the remeasurement date, the employer must reflect the subsidy in the APBO at that date and account for it as an actuarial experience gain, even though the employer may never receive the subsidy if the plan is amended to pay secondary to Medicare Part D.
- If the employer determines that the plan would not have been actuarially equivalent, or if the employer is unable to determine whether the plan would have been actuarially equivalent, the employer must next determine whether the secondary effects of the Act (such as changes in participation rates or claims costs) would be such that enactment is a "significant event." If the employer determines that enactment is a significant event, then APBO must be remeasured reflecting the secondary effects of the Act, with the change accounted for as a gain or loss.
- A second remeasurement is required at the plan amendment date, if the amendment is a
 "significant event." The plan amendment's effect on the subsidy, if any, is combined with its
 effect on expected future benefits, but accounting for the combined change in APBO varies
 depending on how the amendment affects eligibility for the subsidy:

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- If the amendment does not change the employer's eligibility for the subsidy, it is accounted for as a prior service cost (credit).
- If the amendment causes the employer to become eligible for the subsidy (i.e., the
 amendment increases plan benefits to become actuarially equivalent to Medicare Part D),
 and the combined effect is a reduction in APBO, it is accounted for as a gain.
- If the amendment causes the employer to become eligible for the subsidy (i.e., the
 amendment increases plan benefits to become actuarially equivalent to Medicare Part D),
 and the combined effect is an increase in APBO, it is accounted for as a prior service
 cost.
- If the amendment causes the employer to lose eligibility for the subsidy (i.e., the
 amendment reduces plan benefits such that the plan is no longer actuarially equivalent to
 Medicare Part D), the combined effect is accounted for as a prior service cost.
- If the employer determined that the plan, as in effect on the remeasurement date, would have been actuarially equivalent, then during the time between the two remeasurement dates when the subsidy affects the employer's accounting the employer's income tax accounting must reflect any plan-related temporary differences as if the subsidy did not exist, essentially requiring two sets of calculations, even if the plan has been amended to no longer be actuarially equivalent and the employer will never receive the subsidy.

We believe this accounting treatment could be less complex and burdensome for employers that amend their plans in a timely fashion in response to the Act. In addition, it produces inconsistent results for some employers, as illustrated by the following example.

Example. A calendar year employer sponsors an unfunded retirce health plan which only provides benefits to employees who retired before 2000. The employer elected to defer recognition of the Act pending further FASB guidance. The employer amortizes unrecognized net gains (losses) that exceed 10% of APBO in accordance with FAS 106 paragraph 59. Because the plan has no active participants, the amortization of gains (losses) and prior service cost is based on the average remaining life expectancy of inactive participants, which is 10 years. The discount rate is 6%.

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The employer amends the plan, prior to the proposed FSP's effective date, to be secondary to Medicare Part D. To comply with the proposed FSP, the employers first determines that, as of December 31, 2003, the plan would have been actuarially equivalent to Medicare Part D, even though the employer will never receive the subsidy because of the subsequent amendment. The table below shows the funded status and net periodic postretirement benefit cost before reflecting the Act, after reflecting the subsidy, and after reflecting the plan amendment.

	Before reflecting the Act	After reflecting the subsidy	After reflecting the amendment
Funded status			
APBO	\$100,000	\$90,000	\$95,000
Fair value of plan assets	0	0	0
Funded status	(100,000)	(90,000)	(95,000)
Unrecognized net actuarial loss (gain)	5,000	(5,000)	(5,000)
Unrecognized prior service cost	0	0	5,000
Net amount recognized	(95,000)	(95,000)	(95,000)
Net periodic postretirement benefit cost			
Service cost (the plan has no active participants)	0	0	0
Interest cost at 6%	6,000	5,400	5,700
Gain (loss) amortization	0	0	0
Prior service cost amortization	0	0	500
Total	\$6,000	\$5,400	\$6,200

The complex accounting required by the proposed FSP produces the illogical result that enactment of the Act reduces the employer's postretirement benefit obligation but increases the employer's net periodic postretirement benefic cost.

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Simplified accounting alternative. Because the federal subsidy and Medicare Part D coverage provided by the Act will not take effect until 2006, we believe it is reasonable and appropriate to provide a simplified accounting alternative for employers that amend their plans in response to the Act before the effective date of the FSP. These employers should not be required to:

- determine actuarial equivalence or secondary effects of the Act under plan provisions no longer in effect;
- account for a subsidy they will never a receive or perform additional calculations to track income tax effects related to such a phantom subsidy; or
- perform multiple remeasurements to reflect enactment and plan amendment at different times, when both the Act and the amendment do not take effect until future years.

Instead, we recommend that the FSP permit such employers to recognize the combined effect of the Act and the plan amendment as of the remeasurement date when the amendment is adopted, and the combined effect is accounted for as a prior service cost. There would be no recognition of the subsidy prior to the remeasurement date, as seems to be indicated under paragraph 23. Our proposed alternative would greatly simplify the required calculations and substantially reduce employers' cost of complying with the FSP. It would also eliminate the inconsistent results illustrated in the example above. For most employers, the net effect of following this simplified accounting will be little different from the costly and complex accounting required by the proposed FSP.

Areas where further guidance is needed

Q1 – Accounting for amendments adopted before January 31, 2004 (paragraph 23). If an employer with calendar quarters (the remeasurement date determined in accordance with the second sentence of paragraph 23 is December 31, 2003) amends its retiree prescription drug plan between December 31, 2003 and January 31, 2004, should the effect of the plan amendment and the consequential effects of the subsidy be accounted for on a combined basis? The next to last sentence of paragraph 23 appears to require combined treatment, but the last sentence says amendments after December 31, 2003 should be ignored in performing the remeasurement.

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Proposed answer. The plan amendment and the consequential effects of the subsidy should be combined.

Q2 – Accounting for amendments to pay secondary to Medicare Part D (paragraph 23). If an employer amended its plan before the remeasurement date in paragraph 23 (or before January 31, 2004; see Q1) to provide retiree prescription drug benefits that will be secondary to the new Medicare Part D benefit beginning in 2006, how should the amendment be accounted for? Paragraph 23 refers the reader to paragraph 16 of the FSP, but this paragraph only applies to amendments to make a plan actuarially equivalent to Medicare Part D.

Proposed answer. The effect of the plan amendment should be combined with other effects of the Act (changes in participation rates or health care claims costs) and accounted for as a prior service cost (credit) as of the date the amendment was adopted.

Q3 – Reflecting the subsidy in the reconciliations of obligations and assets. FAS 132(R) requires a reconciliation of beginning and ending balances of the benefit obligation and fair value of plan assets. Starting in 2006, how should the subsidy be reflected in the reconciliation of obligations or assets? Should a separate line be shown for the subsidy in the reconciliations?

Proposed answer. There are two acceptable answers: (1) Because the subsidy has been anticipated in the benefit obligation, the subsidy should be treated as a negative benefit payment in the reconciliations of obligations and assets; or (2) Show separate lines in the reconciliations for the subsidy.

Q4 – Time when subsidy is reflected in reconciliations. Although we do not yet know what the process will be for determining the amount of the subsidy payable to a particular employer and how quickly the subsidy will be paid, we believe it is likely that there will be a lag of at least one year between the time when benefits giving rise to the subsidy are paid to or on behalf of plan participants and the time when the subsidy is paid to the employer. When this is the case, should the subsidy be reflected in the reconciliation of obligations and assets when it is accrued (i.e., when the benefits are paid which give rise to the subsidy) or when the employer receives the cash payment?

Proposed answer. The subsidy should be reflected when it is accrued.

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Q5 - Reflecting the subsidy in cash flow disclosures. FAS 132(R) requires disclosure of benefits expected to be paid in the next 10 years and contributions expected to be paid in the next fiscal year. How, if at all, should the subsidy be reflected in these disclosures?

Proposed answer. The subsidy should be reflected in benefits expected to be paid in the next 10 years as a negative benefit payment.

Q6 – **Medicare Advantage Prescription Drug Plans.** What is the accounting treatment for an employer that provides prescription drugs to retirees through a Medicare Advantage plan that the employer expects to qualify as a Medicare Advantage Prescription Drug plan in 2006?

Proposed answer. Medicare Advantage (MA) plans will be eligible to receive subsidies from the government if they provide prescription drug coverage that is at least actuarially equivalent to the standard drug benefit provided in Medicare Part D. If the employer expects that the Medicare Advantage plan will qualify for the subsidy, the employer may anticipate that premiums will be reduced in 2006 to reflect the subsidy. The anticipated reduction in premium should be treated as an actuarial gain.

Q7 – Different benefits for different retirees. How should an employer account for a retiree health plan that provides different prescription drug benefits to different groups of retirees, such that some groups receive benefits that are actuarially equivalent to Medicare Part D, some groups receive benefits that are not actuarially equivalent, and actuarial equivalence cannot be determined for some groups?

Proposed answer. Because eligibility for the subsidy will be determined separately for each retiree group, the employer should treat the different prescription drug benefit levels as separate component plans, and account for each component plan in accordance with the FSP.

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We appreciate the opportunity to provide comments and look forward to a continuing dialogue on these issues.

Sincerely.

Asghar Alam, FSA, MAAA, EA US Retirement Practice Leader George B. Wagoner, FSA, FCA, MAAA Chief Actuary, Health & Group Benefits

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