MINUTES

To:	Board Members
From:	FASB Staff Position No. FAS106-b Team (Rohrkemper, ext. 284)
Subject:	Minutes of the February 18, 2004 Board Meeting
Date:	February 23, 2004
Cc:	FASB: Bielstein, Smith, Petrone, Cassel, Durbin, Rohrkemper, Hamilton, Vernuccio, FASB Intranet

Topics: Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003: Accounting for the federal subsidy available under the Act within the context of Statement 106.

Basis for Discussion: Board memorandum dated February 9, and additional supplement dated February 16, 2004

Length of Discussion: 4:05 - 5:15 p.m.

Attendance:

Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Trott
	Seidman by phone
Board members absent:	None
Staff in charge of topic:	Durbin
Other staff at Board table:	Smith, Cassel, Rohrkemper
Outside Participants:	None

Summary of Decisions Reached:

The Board discussed the staff's proposed alternatives for accounting for the federal plan-sponsor subsidy provided by the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) within the context of FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* The Board decided:

1. The effects of the subsidy on benefits attributable to past service should be treated as an actuarial gain under Statement 106
2. The effects of the subsidy on benefits attributable to future service should be recognized as a reduction to future service cost under Statement 106
3. If a plan, as constructed immediately prior to the date of enactment, is not actuarially equivalent under the Act, and is amended so as to become actuarially equivalent, the effect of the plan amendment together with the consequential effect of the subsidy taken into account in measuring the amendment should be combined into a single measurement.
    a. If the combined effect is a reduction in the accumulated postretirement benefit obligation (APBO), that amount should be considered an actuarial gain.
    b. If the combined effect is an increase in the APBO, that amount should be considered prior service cost associated with the plan amendment.
4. If a plan, as constructed immediately prior to the date of enactment, is actuarially equivalent under the Act and is subsequently amended so as to cease actuarial equivalency
    a. The effects of the subsidy as of the date of enactment should be accounted for as an actuarial gain measured as of the date of enactment (or, December 31, 2003, as a proxy for the date of enactment)
    b. The effects of the negative plan amendment should be accounted for as of the date the amendment is adopted based on the reduced measure of the APBO reflecting the previously measured effects of the subsidy.

5. With respect to income tax accounting, the subsidy, when recognized in subsequent periods via amortization of the actuarial gain or as a component of current period service cost, should not affect the temporary difference otherwise attributable to accrued postretirement benefit cost (the liability recognized in the statement of financial position). That is, the tax-exempt nature of the subsidy should be reflected in the income tax accounting when the subsidy is recognized as a reduction to accrued postretirement benefit cost. The Board directed the staff to include in the guidance an example illustrating that decision.

The Board discussed but did not reach a decision on the transition provisions and effective date for the proposed guidance. The Board directed the staff to provide additional information on the consequences of various transition and effective date provisions for plans as to which actuarial equivalence may be unclear as of the date of enactment and thereafter due to the lack of final regulations or for other reasons.

Matters Discussed:

At the February 11, 2004 Board meeting, the Board decided that the subsidy provided by the Act should be accounted for as a component of net periodic postretirement benefit cost within the context of Statement 106. At the February 18, 2004 Board meeting, the Board discussed how to account for the subsidy within the context of that Statement. For purposes of the current deliberations, the Board and staff are working under the assumption that the subsidy will only be available to sponsors of plans in which the *employer-funded benefit* (not the benefit provided regardless of whether the employer or employee funds the plan) is at least actuarially equivalent to the Medicare Part D plan.

Issue 1: Effect of the Subsidy on Benefits Attributed to Prior Service

The staff proposed three alternative treatments for the effect of the subsidy on benefits attributed to prior service: (a) an actuarial gain,[1] (b) a negative plan amendment[2] or (c) immediate recognition in the period of enactment.[3] The staff recommendation was split between the actuarial gain and immediate recognition alternatives. Mr. Durbin outlined the arguments for and against each alternative as follows:

Actuarial Gain Treatment

+ Consistent with treatment of other changes in Medicare coverage that affect employer's net health care costs.

– Employers had no expectation as to whether they would receive Medicare contributions to prescription drug costs. Therefore, this change does not represent a change in an actuarial assumption or an experience different from that assumed.

Negative Plan Amendment Treatment

+ Some have argued that the passage of the Act represents an amendment to the substantive plan; however, the staff believes that is true only for plans that included a Medicare "carve-out."

– Because the benefits available to participants are not directly affected by the Act, the subsidy does not represent a plan amendment.

Immediate Recognition Treatment

+ Consistent with conclusion in EITF Issue No. 03-2, "Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities," involving an "off-market" transfer of pension obligations to the Japanese government.

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[1] Though not defined in Statement 106, the phrase *actuarial gain* has come to refer to the gain or loss contemplated in that Statement that arises from a change in the value of the APBO resulting from experience different from that assumed or from a change in an actuarial assumption. Under Statement 106, actuarial gains are initially deferred in the period in which they arise, netted together with gains and losses from other sources and subject to the corridor amortization approach.

[2] A negative plan amendment is a change in the existing terms of a plan that decreases benefits, including those attributed to years of service already rendered. Similar, though not identical, to the treatment for actuarial gains, the reduction in the APBO resulting from a negative plan amendment is initially deferred, and, after being offset against any unrecognized prior service cost and/or unrecognized transition obligation, amortized.

[3] Immediate recognition of the benefits of a government subsidy, such as the one provided by the Act, on the APBO is not contemplated in Statement 106. The staff proposal is for any immediate recognition to be limited to the portion of the subsidy related to health care costs that are included in the recorded OPEB obligation, not the total APBO.

+ The fact that the government chose to provide the subsidy in a form that effectively reduces an employers postretirement benefit obligation does not change the fact that the substance of the arrangement is a subsidy, for which there is precedent for immediate recognition (similar to changes in tax rates under Statement 109).
+ Preferable, on conceptual grounds, to deferral and amortization treatment, which has been highly criticized in recent years.
– Not explicitly contemplated in Statement 106.

Mr. Batavick expressed a preference for actuarial gain treatment. He rejected the immediate recognition alternative because it is not contemplated within the context of Statement 106. In his view, Statement 106 is the appropriate context because it addresses healthcare coverage broadly, including prescription drug features, even though it does not specifically address the issue of a government subsidy. Mr. Batavick favored the actuarial gain treatment because, in his opinion, the subsidy represents a change in the Medicare reimbursement program (other changes in that program are also treated as actuarial gains/losses). In response to the charge that the subsidy cannot be viewed as a change in actuarial assumptions because the employer had no expectation of prescription drug coverage or subsidy under Medicare, Mr. Batavick countered that sponsors have made an actuarial assumption—that there would be no subsidy—and upon enactment, that sponsor now has information upon which to change that assumption. Ms. Schipper and Ms. Seidman agreed.

Mr. Schieneman preferred the proposed immediate recognition alternative but did not object to the proposed actuarial gain approach. He expressed concern with the actuarial gain treatment in that it perpetuates the problems in Statement 106 and FASB Statement No. 87, *Employers' Accounting for Pensions*, associated with deferral and amortization of gains and losses associated with certain benefits—the problem of so-called smoothing mechanisms. Mr. Herz shared Mr. Schieneman's concern regarding deferral accounting treatments, but suggested that such concerns would be more appropriately addressed in the context of a comprehensive re-examination of pension accounting. As an alternative, he expressed a preference for the proposed actuarial gain approach.

Mr. Herz asked if any Board members would object to the actuarial gain approach. [No Board members objected.]

Issue 2: Effect of the Subsidy on Benefits Attributable to Future Service

Mr. Durbin noted that the only viable alternative for the treatment of the effect of the subsidy on benefits attributable to future service is to treat such effects as a reduction in service cost in the period in which those prescription drug costs are accrued. [All Board members agreed.]

Issue 3: Interaction of the Subsidy with Subsequent Plan Amendments

The staff pointed out that there are two scenarios for which subsequent plan amendments could interact with the recognition of the subsidy as determined in Issue 1. The first of these scenarios, the "qualifying amendment" scenario, entails that a plan is initially determined to be not actuarially equivalent as of the date of enactment, but, as a result of a subsequent amendment, qualifies as actuarially equivalent. The second scenario, the "disqualifying amendment" scenario, entails that a plan is determined to be actuarially equivalent as of the date of enactment, but, as a result of a subsequent amendment, no longer qualifies as actuarially equivalent.

Qualifying Amendment

For the qualifying amendment scenario, the staff recommended that the effect of the amendment to qualify for the subsidy be combined with the effects of the subsidy and that the combined effects be accounted for as an actuarial gain pursuant to the decision in Issue 1. The staff's rationale for this recommendation is that it would promote consistency in accounting for the subsidy, regardless of whether a plan sponsor initially qualified for the subsidy or subsequently amended its plan so as to qualify.

Mr. Herz noted that the staff's recommendation seemed to assume that the net result of the effect of the subsidy and the amendment would always result in a net reduction to the APBO (a gain) and, therefore, would be treated as an actuarial gain. He pointed out the possibility that the effects of the subsidy in diminishing the overall prescription drug benefit cost could be outweighed by the effects of the amendment to provide additional benefits. Such a scenario would result in a net increase to the APBO (a loss). Mr. Herz agreed with the staff's recommended treatment for circumstances resulting in a net reduction to the APBO, but suggested for circumstances resulting in a net increase, that plan sponsors treat the combined effect as a plan amendment.

Mr. Batavick expressed a preference for an alternative proposed, though not recommended, by the staff that would separate the effect of the subsidy from the effect of the amendment. This alternative would treat the effects of the amendment as a plan amendment unaffected by the subsidy and the direct effect of the subsidy would be treated as an actuarial gain. In Mr. Batavick's view, this alternative would provide greater consistency across companies and over time as changes in the service costs would continue to be reflected through actuarial experience. Mr. Crooch and Ms. Seidman agreed with this preference.

Ms. Schipper disagreed with Mr. Batavick's preference because she viewed the requirement to separate the effect of the amendment from the effect of the subsidy as not operational. Because she could not conceive of a mechanism for differentiating the two effects and for the reasons stated by Mr. Herz, Ms. Schipper agreed with the staff recommendation with Mr. Herz's proposed modification. [All Board members agreed.]

Disqualifying Amendment

For the disqualifying amendment scenario, the staff recommended that the subsequent amendment to disqualify the plan for the subsidy be deemed to be evidence of intent never to qualify for the subsidy. Therefore, under this recommendation, the unamortized portion of the actuarial gain initially arising from the subsidy would be recharacterized as a negative plan amendment and accounted for prospectively pursuant to Statement 106.

Mr. Trott agreed that it is difficult to justify accounting for a disqualifying amendment as anything other than a negative plan amendment. However, he disagreed with the staff's recommendation to recharacterize the unamortized portion of the actuarial gain that initially arose. Ms. Schipper pointed out that some constituents could fairly argue that a disqualifying amendment was not done in order to avoid actuarial equivalency. For this reason, she agreed with Mr. Trott's recommendation to treat a subsequent disqualifying amendment as an event separate from the effects of the enactment, which would call for a treatment as a plan amendment without recharacterization. [All Board members agreed.]

Issue 4: Taxes

The staff recommended that the temporary difference related to the accrued postretirement benefit obligation should be measured based on the recorded obligation plus (adding back) the subsidies that reduce that recorded amount. The staff noted that that approach properly recognizes the favorable tax treatment of the subsidies in the period in which the subsidies are recognized for financial reporting purposes. [The Board unanimously agreed with the staff's recommendation]

Ms. Schipper indicated that an illustration of this guidance would be helpful to constituents and the Board directed the staff to provide an example illustrating how the income tax effect of the subsidy would be reflected.

Issue 5: Transition

The Board discussed two transition alternatives based on the decision regarding the accounting for the retroactive effects of the subsidy as an actuarial gain:

(1) <u>Next measurement date</u>: Reflect the effects of the subsidy in the next scheduled measurement date for the plan and account for any resulting effects prospectively

(2) <u>Cumulative effect</u>:

a. Calculate the effects of the Act as of December 8, 2003

b. Determine the cumulative effect of the revised amount of unrecognized gains and losses on any amortization from December 8, 2003, until the beginning of the fiscal period containing the date of adoption

c. Report the cumulative effect pursuant to the guidance in Statement 3 if the date of adoption is in other than the first fiscal quarter of an enterprise's fiscal year.

During the course of the discussion, the staff suggested that, as a practical expedient, the guidance could permit the effects of the Act to be calculated as of December 31, 2003, rather than the actual date of enactment; the only consequence of that approach would be to ignore the 23 days of amortization attributable to the post-enactment period of December while facilitating the necessary actuarial calculations.

The Board expressed a general preference for the cumulative-effect alternative, but some Board members raised questions about the transition guidance in situations in which, as of the date of enactment, a plan sponsor may be unable to determine whether a plan is actuarially equivalent as defined in the Act but subsequently becomes able to make such a determination. In particular, Board members expressed concern over the possibility that a plan sponsor might be able to choose when to assert actuarial equivalency thereby frustrating the objective of comparable reporting of the subsidy by all affected entities.

The staff's initial view with respect to that issue was that determination of actuarial equivalency is a matter of fact. Therefore, equally informed and qualified professionals considering the same plan design should reach a consistent conclusion about the equivalency or nonequivalency of that plan or that its status can not be ascertained absent regulations interpreting the Act. If a plan is actuarially equivalent as of December 7, 2003, and the employer elected to defer accounting for the Act under FSP FAS 106-1, then the standard (to be defined) transition guidance would apply. If, on the other hand, the plan was not actuarially equivalent but was subsequently amended, the guidance for plan amendments would apply. Finally, if a plan's status as to actuarial equivalency is unclear as of the date of enactment but subsequently is clarified, the transition guidance would not be relevant for that subsequent determination; the proposed guidance would be applied from that point forward. The staff notes that the Board's conclusion on the treatment of the retroactive effects of the subsidy—actuarial gain—is the same treatment in Statement 106 afforded all changes in estimates. Determining the appropriate point at which to reflect a change to the estimated health care costs related to the subsidy, as with all other changes in actuarial estimates and assumptions, is the responsibility of preparers and their advisors and auditors.

However, the Board directed the staff to consider further the transition provisions of the proposed guidance. In particular, the following questions:

(1) Should the proposed guidance require plan sponsors to evaluate, as of the date of enactment, a plan's actuarial equivalency status?

(2) In cases for which actuarial equivalency cannot be determined for some period of time following the issuance of the final guidance and, subsequently, actuarial equivalence is determined, should the effects of the subsidy be measured:

   a. Retroactive to the date of enactment (or the plan amendment that first made the plan actuarially equivalent, if applicable), or

   b. Only from the date at which actuarial equivalent status is clarified, either by regulations or better information.

Follow-up Items:

Staff to prepare supplemental memorandum regarding additional transition issues raised at today's meeting for discussion at a future Board meeting.

General Announcements:

None.