

# defining issues<sup>®</sup>

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## ALERT

## Accounting for the Prescription-Drug Subsidy

Employers that qualify for a prescription-drug subsidy under Medicare legislation enacted in December must recognize the reduction in costs as employees provide services in future years, according to a new FASB Staff Position.<sup>1</sup> Rooted in Statements 106 and 132, the Staff Position also explains how to account for the effect of the law's federal benefit to retirees on per capita claims costs, the relevant accounting for income taxes, and required disclosures.<sup>2</sup> Most companies subject to the new Staff Position will need to apply its accounting guidance for reporting periods ending after June 15, 2004. The new guidance supersedes an earlier Staff Position on the same subject that allowed employers either to defer or recognize the legislation's effects.<sup>3</sup>

### RECOGNIZING THE SUBSIDY

The Medicare Act introduced, in addition to a prescription-drug benefit for individuals, a federal subsidy to sponsors of retiree health-care plans.<sup>4</sup> The subsidy (28% of beneficiaries' drug costs between \$250 and \$5,000) is available only if the sponsor provides a benefit at least "actuarially equivalent" to the Medicare prescription-drug benefit.

- (1) FSP FAS 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003, May 19, 2004, available at [http://www.fasb.org/fasb\\_staff\\_positions/fsp\\_fas106-2.pdf](http://www.fasb.org/fasb_staff_positions/fsp_fas106-2.pdf).
- (2) FASB Statements No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, December 1990, and No. 132 (Revised), Employers' Disclosures about Pensions and Other Postretirement Benefits, December 2003.
- (3) FSP FAS 106-1, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003, January 12, 2004, available at [http://www.fasb.org/fasb\\_staff\\_positions/fsp\\_fas106-1.pdf](http://www.fasb.org/fasb_staff_positions/fsp_fas106-1.pdf).
- (4) The Act's full title is: Medicare Prescription Drug, Improvement and Modernization Act of 2003.

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Thus the first step for sponsors is to determine whether their plans are actuarially equivalent to the Medicare prescription-drug benefit. These assessments are complicated by the absence of detailed regulations on how to determine actuarial equivalency. Some employers may not be able to assess whether they qualify for the federal subsidy before the anticipated regulations are available and in that case will have to meet disclosure requirements until actuarial equivalency can be determined.

Employers who conclude their plans are actuarially equivalent should account for the federal subsidy attributable to past services as an actuarial gain under Statement 106 that reduces the accumulated postretirement benefit obligation. Most of these employers will find that the reduction will be recognized in future periods, as are other actuarial gains and losses. The federal subsidy attributable to services rendered in current and future periods will also reduce net periodic postretirement benefit cost as the employees provide service.

**Amendments.** Plans that provide prescription-drug benefits not considered actuarially equivalent at the date the Medicare legislation became law may be amended to provide actuarially equivalent benefits. If so, the effect of the amendment on the accumulated postretirement benefit obligation and the prospective effect from any federal subsidy are combined. A combined effect that reduces the benefit obligation is treated as an actuarial gain. A combined effect that increases the benefit obligation is treated as prior service cost and amortized over future periods.

On the other hand, a plan amendment can reduce prescription-drug coverage below the level considered actuarially equivalent. In this case, the combined net effect on the accumulated postretirement benefit obligation is accounted for as prior service cost.

**Income Taxes.** The prescription-drug subsidy is not subject to federal tax. Any amount recognized in the financial statements related to the subsidy will therefore not be a temporary differ-

ence under Statement 109.<sup>5</sup> For this reason, companies will need to maintain information on the accumulated postretirement benefit obligation both with and without the effect of the subsidy.

## PER CAPITA CLAIMS COST

The new prescription-drug benefit can affect the per capita claims cost of an employer whose plan provides prescription-drug coverage. Actuarial assumptions can change because of anticipated changes in the behavior of plan participants. The drug benefit for individuals is voluntary, so employers will have to estimate the rate at which current and future retired employees choose to obtain the benefit.

## TRANSITION

The transition guidance differs depending on whether a company elected to defer or account for the impact of the subsidy under the superseded Staff Position. The manner in which the subsidy is recognized also depends on a company's date for measuring plan assets and liabilities.

**Employers that Deferred.** An employer who concludes at the date it adopts the new Staff Position that its plan was actuarially equivalent at December 8, 2003 (the date the Medicare legislation became law) and that the law's effects are a "significant event," as defined in paragraph 73 of Statement No. 106, may account for the law's effects either retrospectively to the date of enactment or prospectively from the date of adoption. However, recognition of the law's effects depends not only on whether retrospective or prospective transition is adopted, but also on whether the plan was amended between the law's enactment and the date of adoption and on whether the plan's measurement date is the financial-statement date. The Staff Position contains a flowchart and a number of examples illustrating the transition requirements.

If the law's effects are not a "significant event," they are not accounted for until the plan's next measurement date following the date of adoption of the new Staff Position.

(5) FASB Statement No. 109, Accounting for Income Taxes, February 1992.



If an employer is unable to determine whether its plan is actuarially equivalent at the date of adoption of the new Staff Position, it should monitor the plan and assess actuarial equivalency as new information becomes available. If new information—for example, new regulations—confirms that the plan is actuarially equivalent, the employer must determine whether the effect of the federal subsidy is a “significant event.” If it is a “significant event,” the law’s effect is accounted for on the date that actuarial equivalency is determined. If it is not a “significant event,” the law’s effect is accounted for at the plan’s next measurement date.

**Employers that Did Not Defer.** Employers that did not defer under the superseded Staff Position may have applied a method different from what is required by the new Staff Position. If the employer’s accounting differs from the new guidance, adopting that guidance is a change in accounting policy. The cumulative effect of applying the new guidance is therefore reported in the period the guidance is adopted.

## EFFECTIVE DATE

Except for certain nonpublic entities, the new accounting guidance is effective for the first interim or annual period beginning after June 15, 2004. For a nonpublic entity (as defined in Statement 87) that sponsors one or more defined benefit postretirement health care plans providing prescription-drug coverage and has no plan with more than 100 participants, the new Staff Position is effective for fiscal years beginning after December 15, 2004.<sup>6</sup> Earlier application of the new guidance is encouraged in financial statements for any period including or following enactment of the Medicare law that have not yet been issued as of May 19, 2004, the date the new accounting guidance was issued.



Many companies adopting the new Staff Position will find the process demanding, given the need to assess actuarial equivalency and the complex transition guidance. Companies will need to quickly understand the ramifications of the new accounting guidance and how it applies to their particular circumstances to comply with its effective date.

The descriptive and summary statements in this presentation are not intended to substitute for the text of Statements 87, 106, 109, and 132 (Revised) and Staff Positions 106-1 and 106-2 or to be relevant to the specific circumstances of individual entities. All relevant facts and circumstances should be evaluated in complying with the new requirements. Reporting entities should consult the texts of the relevant FASB Statements and the Staff Position and their accounting, actuarial, and legal advisors.

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(6) FASB Statement No. 87, *Employers’ Accounting for Pensions*, December 1985.