DEFENSE CONTRACT AUDIT AGENCY
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IN REPLY REFER TO

PAC 730.3.B.08/2004-02 July 27, 2004
04-PAC-041(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Impact of Medicare Prescription Drug, Improvement and Modernization Act of 2003 on Contractor Postretirement Benefit (PRB) Costs

Summary

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) will reduce PRB costs for contractors who currently provide prescription drug benefits for retirees. Auditors should verify that the contractor's projected indirect cost rates have been reduced for the estimated subsidy the contractor is expected to receive under the Act in each of the applicable forecasted years. Auditors should evaluate the methodology and basis for the contractor's estimated reduction for the subsidy. If the contractor intends to amend, curtail or terminate its prescription drug coverage, auditors should verify that appropriate reductions have been made to the contractor's projected indirect costs for those benefit reductions. Auditors should seek the assistance of the DCMA pension specialist in reviewing the contractor's estimated reduction in PRB costs as a result of the Act.

Background

On December 8, 2003, the President signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003. The Act provides for a voluntary prescription drug benefit under Medicare Part D, effective January 1, 2006. In addition, as an incentive to employers to continue current prescription drug coverage for retirees under their plans, the Act also provides for a subsidy to sponsors of qualified plans starting for plan years that end in 2006. In general, a qualified plan is one that provides prescription drug coverage that is at least equal to the actuarial value of the standard drug coverage under Part D of Medicare. The subsidy is 28 percent of the cost of prescription drugs for Medicare-eligible retirees, after a $250 deductible up to a $5,000 ceiling.

On May 19, 2004, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*. FSP No. FAS 106-2 provides guidance on accounting for the effects of the Act for employers that sponsor postretirement health care plans that provide prescription drug benefits.

As of the date of this guidance, implementing Government regulations covering the prescription drug subsidy provided for under the Act are still being formulated.

Guidance

The Act will reduce PRB costs for contractors who currently provide prescription drug benefits for retirees. As a result of the Act, some employers may terminate their existing prescription drug benefit coverage. Contractors that continue to provide prescription drug benefits for retirees under a qualified plan will receive a subsidy under the Act for a portion of the costs of prescription drugs for Medicare-eligible retirees. Accordingly, contractors that currently provide prescription drug benefit coverage for retirees should reduce estimated PRB costs included in forward pricing rates to reflect the subsidy and/or any planned reductions to the contractor's drug benefit coverage. In addition, contractors that accrue PRB costs for Government contract costing purposes should also reflect the impact of the Act in their incurred PRB costs in accordance with FSP No. FAS 106-2, which is discussed in more detail later in this guidance.

Pay-as-you-go Method

Contractors that account for PRB costs using the pay-as-you-go method for Government contract costing purposes and that qualify for the subsidy (i.e., the contractor's prescription drug coverage is at least equal to the actuarial value of the standard drug coverage under Part D of Medicare), should reduce estimated PRB costs included in forward pricing rates to reflect the subsidy for fiscal years 2006 and forward. Contractors using the pay-as-you-go method should also reflect planned reductions to the drug benefit coverage in forward pricing rates, as applicable.

Accrual Method

FAR 31.205-6(o) requires contractors that accrue PRB costs for Government contract costing purposes to measure and assign the costs in accordance with FAS 106 (except that the transition obligation must be accounted for using the delayed recognition methodology). FSP No. FAS 106-2 requires employers that sponsor PRB plans that provide prescription drug benefits to follow FAS 106, paragraph 40. That paragraph requires that presently enacted changes in relevant laws be considered in current period measurements of net periodic postretirement benefit costs (i.e., current year PRB costs) and the accumulated postretirement benefit obligation (APBO, i.e., the liability for the benefits attributable to service rendered to date). When the contractor initially adopts FSP No. FAS 106-2, the reduction in the PRB liability due to the subsidy associated with services rendered to date is to be accounted for as an actuarial gain pursuant to paragraphs 56 and 59 or 60 of FAS 106. In general, those paragraphs require that amortization of unrecognized net gains or losses be included as a component of current year PRB costs if, as of the beginning of the year, they exceed 10 percent of the greater of the liability or the plan assets. FSP No. FAS 106-2 also requires that the subsidy be included in the measurement of the costs of benefits attributable to current service; i.e., the service cost component of current year PRB costs.

FSP No. FAS 106-2 is generally effective for the contractor's first interim or annual period beginning after June 15, 2004. The first year that the effects of the Act must be reflected in the contractor's financial statements will be 2004 or 2005, depending on whether the contractor concludes that enactment of the Act was a significant event calling for remeasurement on a date other than the contractor's normal measurement date and whether the contractor uses the "retroactive" transition method or the "prospective" transition method under FAS No. 106-2. Auditors should verify that the contractor's forward pricing rates are reduced accordingly.

Contractors that conclude that benefits available under their plans are not actuarially equivalent (and hence they do not qualify for the subsidy), or are unable to conclude whether or not the benefits are actuarially equivalent, are still required under FSP No. FAS 106-2 to measure any other effects of the Act (e.g., changes in estimated participation rates). Furthermore, contractors that are currently unable to conclude whether or not the benefits available under their plans are actuarially equivalent must reconsider whether those benefits are actuarially equivalent when clarifying Government regulations or new information about the interpretation or determination of actuarial equivalency becomes available.

Pay-as-you-go or Accrual Method

The contractor should be able to obtain the information needed to estimate the impact of the Act from the company that administers its prescription drug benefit plan. Auditors should verify that the contractor’s projected indirect cost rates have been reduced for the estimated subsidy the contractor is expected to receive in each of the applicable forecasted years. For contractors that use pay-as-you-go accounting, fiscal years 2006 and forward should be adjusted.

For contractors that use accrual accounting, the first year affected will be the same year that the contractor has to first reflect the impact in its financial statements; i.e. either fiscal year 2004 or 2005. Auditors should evaluate the contractor’s methodology and basis for the estimated reduction. Likewise, if the contractor intends to amend, curtail, or terminate its prescription drug coverage, auditors should verify that appropriate reductions have been made to the contractor’s projected indirect costs for those plan benefit changes. Auditors should seek the assistance of the DCMA pension specialist in reviewing the contractor’s estimated reductions for the prescription drug subsidy and/or any other changes to its prescription drug benefit costs due to the Act.

As of the date of this guidance, implementing Government regulations covering the prescription drug subsidy provided for under the Act are still being formulated. We will issue further guidance, if necessary, once the implementing regulations are finalized.

If FAO personnel have any questions, they should contact regional personnel. If regional personnel have any questions, they should contact Anita Homburg, Program Manager, Accounting and Cost Principles Division, at (703) 767-3250 or DCAA-PAC@dcaa.mil.

/Signed/
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