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In This Issue:

Healthy Financial Reporting and Disclosure

A Summary of the Financial Reporting and Disclosure Implications of the Health Care Reform Legislation

Deloitte and Gibson Dunn[1] have collaborated on the report below, which summarizes certain matters related to accounting and disclosures that public entities may need to consider as a result of the passage of the Patient Protection and Affordable Care Act (HR 3590) and of the Health Care and Education Reconciliation Act of 2010 (HR 4872) (collectively, the "Act"). The effects of the Act on the U.S. economy could be as sweeping as those resulting from the passage of Medicare and Social Security.

The considerations outlined in the report are intended to assist public entities in preparing their financial statements and Management's Discussion and Analysis, and in initiating dialogue with their advisors on the impact of the new legislation. While many of the accounting and disclosure considerations will apply directly to specific industries only, others will have broader applicability. Public entities should therefore consider the provisions of the Act that may directly or indirectly affect administrative or other costs (such as human resources or health care premiums).

The considerations outlined in the report are intended to assist public entities in preparing their financial statements and Management's Discussion and Analysis, and in initiating dialogue with their advisors on the impact of the new legislation.

[1] Gibson, Dunn & Crutcher LLP is a leading international law firm. Consistently ranking among the world's top law firms in industry surveys and major publications, Gibson Dunn is distinctively positioned in today's global marketplace, with more than 1,000 lawyers and 16 offices, including Brussels, Century City, Dallas, Denver, Dubai, London, Los Angeles, Munich, New York, Orange County, Palo Alto, Paris, San Francisco, São Paulo, Singapore, and Washington, D.C. For more information, please visit www.gibsondunn.com.

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A Summary of the Financial Reporting and Disclosure Implications of the Health Care Reform Legislation

April 2010

On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act. Seven days later, the president signed into law a reconciliation measure, the Health Care and Education Reconciliation Act of 2010. The passage of the Patient Protection and Affordable Care Act and the reconciliation measure (collectively, the "Act") has resulted in comprehensive health care reform legislation. The effects of the Act on the U.S. economy could be as sweeping as those resulting from the passage of Medicare and Social Security.

The Act will expand health care coverage by providing the following:

- Medicaid eligibility for approximately 16 million additional people.
- Insurance coverage for approximately 16 million additional people through subsidies to purchase insurance through health care exchanges.
- Dependent coverage through age 26.
- No lifetime or unreasonable annual limits on insurance coverage.
- Health insurance for certain individuals with preexisting conditions.
- A requirement that states maintain current eligibility levels for children in Medicaid and the Children's Health Insurance Plan for a specified period.

The changes to insurance coverage will be largely funded by fees and excise taxes charged to entities in health-care-related industries, by excise taxes on high-cost group health plans (commonly referred to as "Cadillac plans"),[1] by tax increases on high-income individuals, and by reductions to Medicare scheduled payments. The Act will not only affect entities operating in health-care-related industries but other entities as well.

Entities will need to identify and plan for changes related to accounting and disclosures that will result from the Act. For example, public entities may need to add disclosures about the positive or negative impact of the Act in their financial statements and Management's Discussion and Analysis (MD&A)[2] in periodic reports (such as Forms 10-K and 10-Q filings) and registration statements. This document is intended to help public entities begin this process and initiate dialogue with their advisors. Note that there may be business, financial, and disclosure matters other than those discussed herein that public entities should address in light of the Act's passage. Accordingly, public entities and their advisors should also consider other ways in which they might be affected.

Potential Business and Financial Impacts

While not all-inclusive, the following table summarizes certain key provisions of the Act that could affect entities in a range of industries in addition to those related to health care.

Provision of the Act[3]	Effective Date	Business and Financial Impact	Entities Affected[4]
Tax Law Changes			
Change to the Medicare Part D subsidy — An employer offering retiree prescription drug coverage that is at least as valuable as that offered under Medicare Part D is entitled to a subsidy. Entities were previously allowed to deduct the entire cost of providing the coverage, even though a portion was offset by the subsidy. The Act repeals the current rule permitting deduction of the portion of the expense that was offset by the Part D subsidy.	January 1, 2013	Recognized deferred tax assets could decrease now as a result of the elimination of the income tax deduction previously allowed for the Part D subsidy. The increased cost resulting from denial of the deduction will be a factor that employers will take into account as they design or modify their benefit plans. The changes in deductibility could result in employers' being less willing to offer retirees prescription drug coverage.	Entities providing retiree prescription drug coverage

[1] High-cost group health plans are commonly referred to as Cadillac plans. A 40 percent nondeductible excise tax will be imposed on such plans that have annual cost of benefits in excess of $10,200 a year for individuals or $27,500 for families and will be paid by the insurance companies. Dental and vision plans are excluded from the cost of benefits. Thresholds are subject to adjustment based on the Consumer Price Index for all urban consumers (CPI-U) or other changes in the Congressional Budget Office's projections of premium inflation.

[2] The MD&A requirements are in Item 303 of Regulation S-K, which applies to public entities in their filings with the SEC. This document is primarily written in the context of public entities, although private entities may wish to give consideration to these matters if they prepare similar disclosures.

[3] For additional insight on specific provisions of the Act, see Deloitte's Prescription for Change 'Filled' — Tax Provisions in the Patient Protection and Affordable Care Act and Gibson Dunn's client alert, The Impact of Health Care Reform on Employers.

[4] Technical Library: The Deloitte Accounting Research Tool (DART) contains numerous questions and answers (Q&As) with interpretations relevant to many accounting topics affected by the Act. Entities are encouraged to use the resources in DART. Of particular help will be the sections in Deloitte's FASB Accounting Standards Codification Manual on contingencies, subsequent events, accounting estimates, and income taxes.

Provision of the Act	Effective Date	Business and Financial Impact	Entities Affected
Tax Law Changes			
Health insurance providers' deductibility of executive and employee compensation is limited to $500,000.	Limits will apply to current compensation paid in years after 2012 but will apply to deferred compensation earned after 2009.	Tax liability could increase as a result of a smaller compensation deduction. The changes in deductibility could result in employers' being less willing to pay executives and employees amounts in excess of $500,000 as well as affect their ability to attract and retain talent.	Health insurance providers
The $1.01 per gallon tax credit for production of certain biofuels under IRC Section 40(b) has been amended to preclude wood pulp byproducts, known as "black liquor," that paper manufacturers use to power their mills.	Fuels used or sold after December 31, 2009	Tax credits available will decrease, resulting in an increased tax liability.	Entities receiving tax credits for use of biofuels such as black liquor
Penalties			
Penalties imposed on employers that do not withhold sufficient Medicare payroll taxes for employees.	January 1, 2013	The employer's share of Medicare tax is unchanged; however, if an employer fails to collect the appropriate tax from the employee (e.g., if the individual employee's compensation does not trigger additional tax, but the employee's compensation combined with his or her spouse's does trigger the tax),[5] penalties will be assessed on the employer. Employers may face a greater administrative burden as they develop procedures to ensure that they are withholding the proper amounts from employees' pay.	Employers of highly compensated employees, or employees whose compensation when combined with their spouse's, meet the definition of highly compensated
Penalties imposed on employers that have 50 or more full-time employees and do not provide insurance to employees.	Tax years beginning after December 31, 2013 (phased in 2014–2016)	Costs may increase because of penalties paid by employers that do not provide insurance to all employees or because of the insurance employers ultimately provide. Certain employers may resist hiring additional employees if it will cause them to exceed the thresholds in the Act.	Specified employers that do not provide insurance to all full-time employees
Hospitals with readmission rates above a certain threshold will have payments for the original hospitalization reduced by 1% if a preventable readmission was within seven days of the original hospitalization.	January 1, 2013	Medicare payments for hospitalized-patient care may decrease if patients are readmitted. Hospitals may change their operations (e.g., longer stays per patient) to achieve a lower readmission rate.	Hospitals

[5] An additional Medicare payroll tax of 0.9 percent applies to wages (or self-employment income) received by highly compensated employees ($200,000 for single filers and $250,000 for joint filers).

Provision of the Act	Effective Date	Business and Financial Impact	Entities Affected
Overall Cost Increases/Administrative			
Additional reporting requirements, including the following: • W-2s must include aggregate cost of employer-sponsored health benefits. • Business payment (1099) reporting expanded, requiring persons engaged in a trade or business to report on payments of other fixed and determinable income or compensation. • To comply with individual and employer mandates and avoid penalties, (1) insurance providers that offer the minimum essential health coverage to an individual must report certain information to the covered individual and the Treasury Secretary and (2) large employers subject to the rules to maintain minimum essential coverage must file a return that (a) identifies the employer, (b) certifies whether it offers to its full-time employees the option to enroll in a minimum essential coverage plan, (c) states the number of full-time employees in each month of the calendar year, and (d) supplies information identifying each full-time employee covered under the employer-provided health plan.	W-2: 2011 Business payment: Payments made after December 31, 2011 Individual mandated information: Calendar years beginning after 2013	Employers will have to file a significant amount of additional information with the IRS and will have to develop systems and processes to track the requisite information, which could potentially lead to an increase in general and administrative expenses.	All entities subject to the reporting requirements
Changes to requirements for group health plans: • Employers that have over 200 full-time employees must automatically enroll their employees in the plan; however, employees may opt out after demonstrating acceptable coverage. • Penalties are imposed on employers that have at least 50 employees and whose plans impose an extended enrollment waiting period.	January 1, 2014	Number of employees covered upon hire will increase and waiting period for coverage will decrease, which could lead to increased health care costs for affected employers. Certain employers may resist hiring additional employees if it will cause them to exceed the thresholds in the Act. Health care providers and insurance entities will need to assess their operational capacity to respond to pent-up demand from the newly insured.	All entities
Secretary of Health and Human Services determines annually the benefit package essential to basic health that will be required in all health insurance plans offered through health exchanges or commercial plans.	January 1, 2014	This could cause potential variability in health insurance fees charged because of changes in benefits that must be provided. Health care providers will need to assess the potential impact of increased coverage on their profit margins.	Health insurance providers and all entities paying fees for group health insurance plans
Excise Taxes, Industry Fees, and Industry Legal Changes			
Nondeductible industry fee imposed on pharmaceutical manufacturers according to the individual manufacturer's relative percentage of total industry sales to specified government programs.	First payment due in 2011	Entities may need to adjust earnings forecasts, including those provided to analysts, as well as assess the impact that any increased fees could have on their ability to invest in research and development (R&D) over the longer term.	Branded pharmaceutical manufacturers

Provision of the Act	Effective Date	Business and Financial Impact	Entities Affected
Excise Taxes, Industry Fees, and Industry Legal Changes			
The Food and Drug Administration is given the authority to approve generic versions of biologic drugs. Manufacturers of branded biologic drugs are granted 12-year exclusivity periods before generics may be marketed.	Effective upon enactment of the Act	Increased competition in the biologic drug industry from generic drug manufacturers (after the 12-year exclusivity period and/or expiration of related patent rights) may affect the future earnings potential of an entity's branded drug technology. The approval of generic biologic drugs may also affect a generic drug manufacturer's earnings potential. Branded biologic drug manufacturers that have intangible assets recorded for the value of a branded biologic drug may need to reassess the estimated useful lives of such intangibles. Entities may need to adjust earnings forecasts provided to analysts and record additional rebate accruals.	Manufacturers of branded and generic biologic drugs
Increase in certain Medicaid drug rebates paid by pharmaceutical manufacturers.	January 1, 2010	Medicaid rebates paid will increase for sales of certain drugs. Entities may need to adjust earnings forecasts provided to analysts and record additional rebate accruals.	Pharmaceutical manufacturers
Imposition of a 2.3% excise tax on medical device manufacturers.	January 1, 2013	Entities may need to adjust earnings forecasts, including those provided to analysts.	Medical device manufacturers
Nondeductible industry fee imposed on health insurance providers according to the individual provider's relative percentage of total industry premiums written.	January 1, 2014	Entities may need to adjust earnings forecasts, including those provided to analysts.	Health insurance providers
Imposition of a nondeductible 40% excise tax on the "excess benefit" provided under Cadillac plans.	January 1, 2018	An excise tax is imposed on Cadillac plans. Alternatively, the employer can change (decrease) the benefits offered such that the plan no longer qualifies as a Cadillac plan.	Employers providing Cadillac plans

Period of Accounting for the Act

For accounting purposes, generally the provisions of passed legislation are not accounted for until the period of enactment of the legislation. However, the enactment of the Act through two separate laws raises a question about what period entities should use when they have a period-end that falls between March 23, 2010, and March 30, 2010. Informal discussions with the SEC staff have indicated that the staff would not object if a public entity (whose period-end fell between March 23 and March 30) accounted for the impact of the reconciliation measure as if it had been enacted together with the Patient Protection and Affordable Care Act in the financial statements for the period ended before March 30, 2010.[6] See, for example, the accounting for the elimination of the tax deduction for the portion of the prescription drug costs for which the employer receives a Medicare Part D subsidy (i.e., reduced deduction) for entities with a period-end that fell between March 23 and March 30, which is discussed in Deloitte's Financial Reporting Alert 10-3 (Revised), *Health Care Legislation Eliminates Tax Deduction Related to Medicare Part D Subsidy — Potential Accounting Impact This Quarter*.

Any entity that chooses not to follow this approach and account for the enactment of the two laws in different financial statement periods should consult with its auditors and accounting advisors. The nearly simultaneous enactment of two laws that affect the same financial reporting item over different accounting periods is very unusual; accordingly, the accounting for the enactment of a law in a financial statement period that precedes the enactment date of that law (i.e., including the change to the effective date as a result of the reconciliation measure in financial statements for periods ending before March 30, 2010) is not to be analogized to in other circumstances.

[6] We understand the SEC is considering an announcement confirming this position at an upcoming FASB meeting.

Subsequent-Event Disclosures

Given that many aspects of the Act require interpretation by the Department of Health and Human Services and other governmental agencies, and that the Act was passed in such close proximity to the upcoming quarterly reporting period (as well as any annual reporting periods), entities and their advisors will need to carefully evaluate information that becomes available after the balance sheet date but before the issuance of the financial statements. ASC 855[7] provides guidance on evaluating events that occur after the balance sheet date but that may require adjustment to or disclosure in the financial statements. A recognized subsequent event consists of events or transactions that provide additional evidence about conditions that existed as of the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. A recognized subsequent event requires adjustment to the financial statements. A nonrecognized subsequent event consists of events that provide evidence about conditions that did not exist on the date of the balance sheet but arose after that date. Such events should not result in adjustment of the financial statements. Determining whether an event related to the Act, or a subsequent agency interpretation, is a recognized or nonrecognized subsequent event requires careful consideration by management.

Other Disclosure Considerations

Every entity that is required to file Exchange Act reports will need to analyze how the Act may affect its operations to determine whether the Act has triggered any new disclosure obligations.[8] In evaluating the disclosures that may be required as a result of the Act, entities will need to assess the impact of the Act on the industry in which the entity operates, not just the entity itself. Although public entities may need to add disclosures regarding the material ramifications of the Act to various sections of their Forms 10-Q and 10-K filings, the section that will most likely require additional disclosure regarding the impact of the Act will be known trends and uncertainties, as discussed in MD&A.[9]

MD&A is intended to provide investors with a stand-alone, clear, and comprehensive historical and prospective disclosure of an entity's analysis of its financial results, so that investors may evaluate, through the eyes of management, the quality of an entity's financial condition and results of operations. To this end, an entity is required to identify and discuss in its MD&A any known trends or uncertainties that are reasonably likely to have a *material effect* on the entity's liquidity, capital resources, or operating results. Accordingly, an entity's determination of whether it is appropriate to disclose known trends and uncertainties should involve (1) consideration of financial, operational, and other information known to the entity about trends and uncertainties and (2) assessment of whether the known trends and uncertainties will have, or are reasonably likely to have, a material impact on the entity's liquidity, capital resources, or operating results.

General examples of known trends include a change in market share over time, quarter-over-quarter weakening or strengthening of the economy, and major line items in the financial statements (e.g., revenues, net income, cash flow from operations) increasing or decreasing in one direction for several quarters. General examples of uncertainties include environmental cleanup costs, pending litigation, currency fluctuations, and pending legislation.

When pending legislation is enacted, an entity must analyze it to determine what, if any, material effect it might have on the entity. The sweeping overhaul of the health care system is an example of an event that an entity should evaluate to determine whether its effect on the entity warrants discussion in MD&A about known trends or uncertainties.

Entities are likely to fall into one of two categories in the evaluation of whether any additional disclosure requirements have been triggered by the Act: (1) those not operating in a health-care-related industry and (2) those operating in a health-care-related industry. The discussion below is intended to shed some light on the potential disclosure considerations for each of those two categories of entities.

[7] FASB Accounting Standards Codification Topic 855, *Subsequent Events*.

[8] For instance, some public entities have already started to disclose in Form 8-K filings substantial noncash charges related to the change in the tax treatment of the Medicare Part D subsidy (see discussion herein).

[9] Other areas that may require additional disclosure regarding the Act include the description of the business in Form 10-K and the executive-level overview section of MD&A and Risk Factor disclosures in Forms 10-Q and 10-K.

Potential Disclosure Considerations for Entities Not Operating in a Health-Care-Related Industry

Although each public entity will need to analyze the Act on the basis of its own facts and circumstances to determine what, if any, disclosure should be made in its securities filing, this section highlights the provisions of the Act that are more likely to warrant disclosure considerations for an entity that is not operating in a health-care-related industry.

- *Changes to Medicare Part D subsidy* — An entity offering retiree prescription coverage that is equal to or greater than the Medicare prescription coverage is entitled to a subsidy. Before the Act, entities were allowed to deduct the entire cost of providing the retiree prescription coverage even though a portion was offset by the subsidy. However, under the Act, the tax deductible prescription coverage is now reduced by the amount of the subsidy. As a result, some entities will be forced to take a noncash charge in connection with the impairment of their deferred tax assets related to the Medicare Part D subsidy. Because of the increased cost resulting from the elimination of the deductibility of the Medicare Part D subsidy, entities will need to determine whether changes to their current retiree medical benefits are warranted. To the extent that such charges are taken and they are material, disclosure about the charge may be needed in an entity's financial statements and MD&A.
- *Excise tax on Cadillac plans* — Beginning in 2018, the Act imposes a nondeductible 40 percent excise tax on the "excess benefit" provided under Cadillac plans. An excess benefit is a benefit the cost of which, on an annual basis, exceeds $10,200 a year for individuals or $27,500 for families. The excise tax will make Cadillac plans significantly more expensive than they are currently, and the tax could be a factor that entities take into account as they determine whether to change or continue to offer Cadillac plans. Disclosure may be required if entities start modifying their Cadillac plans to avoid the excise tax.
- *Disclosure controls and procedures, and internal control over financial reporting (ICFR)* — The Act may cause a public entity to implement new, or modify existing, ICFR and disclosure controls and procedures, as discussed below.

In addition to the specific provisions noted in the table and those described above, entities may also need to consider the following questions in determining whether disclosure within MD&A is needed:

- Will the Act affect when an employee is eligible to begin receiving benefits or the types of benefits the entity offers?
- How does the Act affect the entity's results of operations, either as a result of increased coverage to employees or the penalties assessed if coverage is not provided? Has the entity evaluated the impact that any additional expenses may have on its debt covenants?
- What are the effects of the Act on the entity's liquidity, either with respect to the timing or amount of tax payments or as a result of additional employee benefit costs?

Potential Disclosure Considerations for Entities Operating in a Health-Care-Related Industry

This section pinpoints specific areas of the Act that should be considered for their effect on the disclosure requirements of entities that operate in a health-care-related industry.

- *High readmission rates* — Hospitals with unacceptably high readmission rates will have Medicare hospitalization payments reduced by 1 percent if the readmission was preventable and within seven days of the original hospitalization. The potential decrease in payments could be a factor that hospitals take into account when setting operations protocols (e.g., setting the length of time a patient stays or the maximum number of patients that can be admitted at any given time). To the extent that the potential decrease in payments received are material, or could lead to changes in a hospital's operational procedures, disclosure may be needed in MD&A.
- *Industry-specific excise taxes and fees* — Several health-care-related industries will be charged additional taxes and fees under the Act. For example, branded pharmaceutical manufacturers will be charged a nondeductible fee, health insurance providers will be charged a nondeductible fee based on the insurance provider's relative percentage of total industry premiums written, and medical device manufacturers will be assessed a 2.3 percent annual excise tax. To the extent that these excise taxes and fees are or are expected to be material, disclosure may be needed in MD&A.

Finally, in addition to the specific provisions noted in the table and those described above, health care providers, insurance providers, and pharmaceutical manufacturers may need to consider additional questions about potential disclosure within MD&A and Risk Factor disclosures,[10] such as the following:

- Does the entity have the operational capacity to respond to pent-up demand from the newly insured?
- Has the entity estimated the potential impact of increased coverage on its profit margins?
- If reimbursement rates are dramatically reduced, could the entity sustain positive margins and replenish capital over the medium to long term?
- Does the entity have sufficient capital to support the investments that will be required for the entity to succeed in a postreform environment (e.g., health information technology)?

Pharmaceutical manufacturers also may need to consider whether disclosure is required as a result of their responses to the following questions:

- Will the changes in pricing and reimbursement affect the entity's ability or trends in investment level of R&D over the longer term?
- Will operational and structural changes be necessary to support long-term profitability and success in a changing environment?

Internal Control Considerations

As indicated in the previous section, the Act may cause a public entity to implement new, or modify existing, ICFR and disclosure controls and procedures. Examples of potential changes to internal controls and processes may include the following:

- Development of a process in which the entity may gather, prepare, and timely file with the IRS all newly required information.
- Development or changes to controls related to estimation processes, such as incurred but not-reported health care claims, potential tax penalties for noncompliance, payroll tax withholdings, excise tax accruals, and Medicaid rebate accruals.
- Development of controls related to the timely adoption of all changes in plan provisions, including dependent coverage extension, automatic enrollment, and decreased waiting period for coverage.
- Development of controls related to accurate tax calculations as a result of changes in allowable deductions and the elimination of the Medicare Part D subsidy.
- Development or changes to security and privacy processes because of certain provisions in the Act.

New or modified controls related to the selection and application of generally accepted accounting principles for items arising as a result of the Act may be necessary and will fall within the scope of an issuer's annual evaluation of the effectiveness of ICFR, as required by Section 404 of the Sarbanes Oxley Act. Public entities are also required to consider whether any changes to ICFR are material changes that would require disclosure in Item 4 of Part I or Item 9A, "Controls and Procedures," of their quarterly or annual filings, respectively.

In addition, new or modified disclosure controls and procedures may be necessary, for example, to address the matters discussed in the Other Disclosure Considerations section above. Public entities and their certifying officers will be required to evaluate the effectiveness of such controls as part of their quarterly evaluations of the effectiveness of disclosure controls and procedures in accordance with Section 302 of the Sarbanes Oxley Act.

Communication With Those Charged With Governance and the Entity's Independent Auditors

Management of entities that have been affected by the Act should begin a dialogue with those charged with governance and their independent auditors regarding the effects of the Act on the financial statements and operations. Those discussions should include the significant judgments and estimates that will need to be made (e.g., the estimated relative percentage of industry sales or premiums written for excise tax accrual) as well as the accounting principles to be applied.

[10] Risk factors are the most significant factors that would make an investment in the public entity's securities speculative. Many of the known trends and uncertainties that are discussed in MD&A will also be appropriate for discussion in Risk Factor disclosures.

In addition, affected entities should expect that their independent auditors may also be having discussions with those charged with governance. Independent auditors are required to provide those charged with governance with information regarding the scope and results of the audit that may assist those charged with governance in overseeing the financial reporting and disclosure process for which management is responsible.

Given the significant effect that the Act may have on entities' operations and financial statements, management's discussions with those charged with governance and independent auditors may include how certain items were accounted for and disclosed. The auditor is required to determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Next Steps

The potential ramifications of the Act go well beyond entities that operate in the health care industry. While certain provisions of the Act will more directly affect entities that are health care providers, insurance providers, and pharmaceutical manufacturers, all entities should consider whether additional disclosures are necessary. Entities will need to consider the potential impact of the matters identified in this document, as well as others, and the effect on their financial statements and MD&A in quarterly and annual reporting periods.