AMERICAN ACADEMY of ACTUARIES

Cost Accounting Standards Board
Office of Federal Procurement Policy
725 17th Street, NW
Room 9013
Washington, DC 20503

September 6, 2007

ATTN: Laura Auletta

Re: CAS-2007-02S

Dear Ms. Auletta,

Presented below are the comments of the American Academy of Actuaries[1] Cost Accounting Standards Task Force on the Staff Discussion Paper (SDP), "Harmonization of Cost Accounting Standards (CAS) 412 and 413 with the Pension Protection Act of 2006 (PPA)" issued by the Board, Office of Federal Procurement Policy (OFPP), OMB.

The American Academy of Actuaries Pension Committee established the Cost Accounting Standards Task Force in response to the mandate by Congress for the Cost Accounting Standards Board (the "Board") to review and revise sections 412 and 413 of the CAS to harmonize the minimum required contributions under the Employee Retirement Income Security Act (ERISA). Membership on this task force includes representatives of the actuarial profession employed by the government, by government contractors and by the consulting community who are most knowledgeable and interested in the CAS.

Consistent with the diverse makeup of this task force, our responses represent the collective viewpoints of its members. Accordingly, they should not be viewed as the opinions of any specific individual on the task force. Additionally our comments are not intended to advocate a specific vision of how harmonization should be accomplished. Instead their primary intent is to provide the Board with insights as to effects, intended or otherwise, of alternative approaches that might be considered in the harmonization process.

It is our understanding this SDP and the comments that it elicits represent the first requirement of the OFPP Act of the Board in promulgating cost accounting standards and interpretations as stated in CAS 9901.305; the first step being to:

> "...take into account, after consultation and discussions with the Comptroller General and professional accounting organizations, contractor, and other interested parties—
>
> (i) the probable costs of implementation, including inflationary effects, if any, compared to the probable benefits;
> (ii) the advantages, disadvantages, and improvements anticipated in the pricing and administration of, and settlement of disputes concerning, contracts; and
> (iii) the scope of, and alternatives available to, the action proposed to be taken…."

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession

We anticipate that our comments, as well as other comments that you receive, will be reflected in a report that the Board is to prepare and publish in the *Federal Register*. Hopefully our comments will be useful as the Board prepares an advanced notice of proposed rulemaking, also for publication in the *Federal Register*.

Context

Before responding to the questions posed, it may be helpful to summarize our understanding of how the Board has operated historically. The CAS were established after the passage of ERISA taking into account the practicalities of ERISA funding but addressing different needs. The primary objectives of ERISA are to ensure adequate funding of plans and to protect the interests of plan participants. As indicated in the Board's statement of objectives issued in 1992 the:

> "primary objective of the Board is to promulgate, amend, and revise Cost Accounting Standards designed to achieve (1) an increased degree of uniformity in cost accounting practices among Government contractors in like circumstances, and (2) consistency in cost accounting practices in like circumstances by individual Government contractors over periods of time. In accomplishing this primary objective, the Board takes into account (1) the advantages, disadvantages, and improvements anticipated in the pricing and administration of, and settlement of disputes concerning contracts, (2) the probable costs of implementation, including inflationary effects, if any, compared to the probable benefits of such Standards, and (3) the alternatives available."

Also key in the Board's considerations was an intent for the rules to provide a fair and equitable allocation of costs to contracts and the concept that "the requirement to fund a pension cost pursuant to ERISA made the liability valid and therefore made the cost assignable to the current period."

Illustrating the spirit of harmonization, in developing the original Cost Accounting Standards for pensions, the Board attempted to stay within the general constraints of existing financial accounting (APB-8) and the funding provisions of ERISA. For example, mirroring APB-8 and ERISA, the Board did not require the use of a specific actuarial cost method or asset valuation method, although a requirement for common methodology would have improved uniformity among government contractors. Also, at the expense of uniformity, the CAS Board allowed each contractor to select from the same range of amortization periods for unfunded liabilities that were acceptable under the originally enacted ERISA.

Moving forward to the present, significant changes have been made to both the funding requirements under ERISA and the financial accounting rules applicable to pension costs. However, with the exception of the 1995 amendments focused on addressing the treatment of full funding and segment closings, the CAS has remained largely unchanged. At this juncture the CAS are largely disconnected from ERISA as amended by the PPA and financial accounting in the areas of cost methods, asset valuation methods, assumptions, and amortization periods.

Given the large differences that now exist between the current CAS rules and ERISA and financial accounting, the Board may want to start with a fresh look at the proper approach to assign costs for government contracting purposes rather than focusing on how to adjust the current rules to make them more compatible with the new paradigms. Consistent with the mandate by Congress, this fresh look should start with the new paradigm adopted by the PPA.

1. Scope. Section 106 of the PPA instructs the Board to harmonize the CAS with the minimum required contribution for "eligible government contractors.'' Contracts of "eligible government contractors'' are a small subset of contracts subject to CAS 412 and 413, which include all cost-based contracts subject to full CAS coverage, contracts subject to Paragraph 31.205-6(j) of the Federal Acquisition Regulation, and recipients of financial assistance who have elected to use CAS 412 and 413 under OMB Circular A-87.

Question 1. Should the Board apply any revisions to all cost-based contracts and other Federal awards that are subject to full CAS coverage, or only to ``eligible government contractors'' as defined in Section 106?

Applying the harmonization rules only to eligible government contractors would create an uneven playing field in bidding for future contracts among potential contractors. This may cause potential contractors who are not eligible government contractors to abandon or curtail their pension plans in the interest of remaining financially competitive with eligible government contractors. Such a result is inconsistent with the stated purpose of the Pension Protection Act to provide economic security for all Americans.

In addition, selective application is likely to create substantial complications for contractors who move in and out of the eligible government contractor status. This would appear to be at odds with one of the basic purposes of CAS stated in CAS 9904.401, which is to ensure consistency in the application of cost accounting practices. Such consistency would be impossible if the contractor is moving between statuses under which different accounting rules are applicable.

2. General Purpose. CAS 413.50(c)(12) currently provides for an adjustment of previously determined pension cost in the event of a segment closing, a plan termination, or a curtailment of benefits. The adjustment is computed as the difference between the market value of the assets and the actuarial accrued liability for the segment. If there is a pension plan termination, the actuarial accrued benefit [liability] is measured as the amount paid to irrevocably settle all benefit obligations or paid to the PBGC. In this way, it could be argued that CAS 413-50(c)(12) already satisfies the purpose of the PPA to protect employee retirement security or to ensure the PBGC solvency, at least for the contractor's segments that perform Government contracts. This leads to the following question:

Question 2. Does the current CAS 412 and 413 substantially meet the Congressional intent of the PPA to protect retirement security, to strengthen funding and ensure PBGC solvency?

A primary focus of the PPA in strengthening pension funding is to accelerate funding with a targeted minimum level of assets that at least equals the value of accrued benefits determined using approximate market assumptions. CAS 412 and 413 fall short of this focus in several areas:

- *Under CAS 412, the interest rate assumption is generally required to reflect expected long-term returns on the plan's invested assets. Under the PPA, however, the interest rate assumption reflects the market yields of investment-quality corporate bonds of appropriate duration. This difference in assumptions produces a result in which the funding target under CAS 412 in the current economic environment is lower than that of the PPA.*
- *Under CAS 413, the use of assumptions that represent liabilities marked to market is permissible only in the event of a plan termination or settlement as described under CAS 413-50(c)(12). In all other CAS 413 cases, the assumptions must be consistent with those used under CAS 412. i.e., a long-term outlook versus a marked-to-market approach. Furthermore, if a plan termination occurs during an accounting period in which the employer is not a government contractor, the contractor may never be reimbursed for costs incurred based on liabilities marked to market.*
- *Even in a situation in which the CAS 413 assumptions are on a market basis, the adjustment that it produces is only assignable in the current cost accounting period. Therefore, it contemplates that the funding true-up will be made after the fact. This is in direct conflict with the PPA, which requires accelerated advance funding of marked-to-market liabilities valued on an annual ongoing basis.*

3. Harmonization. The PPA requires that the Board review and revise CAS 412 and 413 to harmonize with the minimum required contribution, but recognizing that the Board has exclusive authority concerning contract cost accounting, leaves the determination of what constitutes “harmonization" to the Board's deliberation and conclusion. The CAS pension harmonization rule could fall anywhere within the continuum from avoidance of conflict with ERISA to full adoption of the measurement and assignment concepts of the minimum required contribution. The rule might be accomplished by changing the current provisions of CAS 412 and 413, or possibly adding an adjustment mechanism to ensure differences between the minimum required contribution and the contract cost are reconciled within a reasonable period of time. There might be other means by which harmonization could be achieved.

Another issue is whether harmonization should examine the minimum required contribution with or without application of the plan's credit (carryover and prefunding) balances. The existence and application of credit balances are treated differently for eight separate PPA funding tests, such as "at-risk" status, benefit restrictions, and the variable PBGC premium. Separate from their concerns with contract costing, contractors will have to make complex decisions about whether to retain or waive (permanently forego) credit balances. If all or some of the credit balance is retained, the contractor must make decisions as to the amount of the credit balance to apply to reduce the minimum funding requirement and in which accounting period to apply the reduction.

Question 3. Should CAS harmonization be focused only on the relationship of the PPA minimum required contribution and the contract cost determined in accordance with CAS 412 and 413?

Even though PPA concentrates on revising the minimum funding requirements, some provisions of PPA also address the maximum deductible limits. While the law instructs the Board to revise CAS 412 and 413 to harmonize with the ERISA minimum funding requirements, some attention must also be given to the CAS 412 and 413 provisions regarding full funding limitations and maximum tax-deductible contributions, not only to reflect the proper references to ERISA and the tax code as revised by PPA (and previous laws) but also to address situations in which the contractor contributes at levels above the assignable costs.

(a) Do the measurement and assignment provisions of the current CAS 412 and 413 result in a contractor incurring a penalty under ERISA in order to receive full reimbursement of CAS computed pension costs under Government contracts?

The Task Force interprets the penalty that is being referred to as a tax penalty in the event that a contractor would need to contribute more than the maximum deductible limit in order to receive full reimbursement under CAS rules. It is unlikely that a CAS assignable pension cost computed using the current rules of CAS 412 and 413 would exceed the maximum tax deductible contribution under either current rules or as amended by PPA. Even if such a situation existed, the current CAS rules regarding assignable cost deficits (CAS 412.50(c)(2)(C)(iii)) should adequately deal with it and, to the extent they continue to apply, would appear to be appropriate to retain.

(b) To what extent, if any, should the Board revise CAS 412 and 413 to harmonize with the contribution range defined by the minimum required contribution and the tax-deductible maximum contribution?

The Board might take a number of alternative to achieve harmonization. One approach would be to largely retain the current rules but revise them to reflect the PPA maximum deductible limits and to add a rule stating that the assignable cost shall not be less than the minimum required contribution under ERISA as amended by the PPA. Such an approach would appear to be the least disruptive of methodologies currently in place, while fully supporting the stated intent of the PPA to provide economic security for all Americans. This approach would serve to accelerate the recognition of costs that would otherwise be assignable In future periods.

A second approach that would fully support the stated intent of the PPA would be to set the assignable cost equal to the minimum required contribution. In the current economic environment, this approach has the appearance of universally producing assignable costs greater than those produced under the current CAS rules. However, an increased interest rate environment similar to that experienced in the 1980s and 1990s would likely produce lower costs. In either case, the de facto funding target would be the market value of benefits earned to date, which may not be consistent with the current fundamental concept of ongoing accounting.

The above approaches would need to consider carefully how the credit balances might interact with the minimum required contributions. Unless objective rules are established for the treatment of credit balances, contractors might be able to exercise more discretion than is preferred. This would reduce the consistency of costs, both from period to period and among contractors. However, care would also need to be taken to avoid a result in which the CAS rules dictate how contractors must choose to utilize credit balances for satisfying minimum funding requirements, as this would seem outside the Board's purview.

A third approach would be to largely retain the current rules but provide some mechanism that allows contractors to recover prepayment credits more rapidly than is allowed under current CAS rules. This might be accomplished by increasing the otherwise assignable cost by an amortization of the difference between the PPA minimum required contribution and the otherwise assignable costs. This approach would essentially be requiring contractors to finance the cost of pension benefits on behalf of the government until full reimbursement. This would represent a loan to the government at an interest rate equal to the rate on which the CAS costs are determined. Recognizing that such prepayment credits are likely to only develop when the yields on corporate bonds are lower than the CAS interest rate and that government treasuries invariably have lower yields than corporate debt, the de facto loan rate would be more than the cost of borrowing that the government could undertake through the issuance of Treasury bonds. Accordingly, such an approach would not reflect the lowest-cost approach the government could take.

From the contractors' perspective, such a loan may not be perceived as the best use of corporate assets and contractors can be expected to consider mitigation strategies. One obvious way to mitigate this result is through termination of the plan with the expectation of recovery through the mechanisms provided under CAS 413. If this approach is used, it strongly suggests that the rules driving this action are contrary to policy that supports a strong pension system. A second approach to mitigation may be for the contractors to revise their investment strategy so that the expected return on assets more closely reflects the interest rate assumption dictated under the PPA. If this approach is used, it suggests that the CAS rules are encouraging investment behavior that may not be in the best long-term interest of the contractor or the government. Contractors who fail to undertake such mitigating steps may find themselves at a financial disadvantage that could impair their ability to retain qualified employees and fulfill their contract requirements.

A fourth approach would be to address the key incompatibilities between the current CAS rules and the PPA. This would suggest changes in the current CAS rules concerning the selection of actuarial assumptions, permissible amortization periods, and acceptable actuarial cost methods for plans providing salary-related benefits. If these incompatibilities are addressed using permissive language, it would continue to allow for different contractors to adopt different approaches in applying the CAS rules. If the incompatibilities are addressed using restrictive language, the impact might be closer to either the second or the third approach, depending on the extent of the changes.

In evaluating these alternative approaches, the Board should also consider how the alternatives might affect consistency among contractors and the extent to which a range of permitted approaches might increase disagreements between the contractor and the government. Fewer choices will create greater uniformity and simpler contract administration.

(c) To what extent, if any, should ERISA credit balances (carryover and prefunding balances) be considered in revising CAS 412 and 413?

ERISA credit balances are developed when employers choose to fund above the minimum funding requirements. The corollary under CAS 412 is prepayment credits. Accordingly, in general, ERISA credit balances should not be considered in revising CAS 412 and 413 if the current scheme of parallel CAS calculations that take into account prepayment credits, assignable cost credits/deficits, etc. is retained. However, the harmonization process should take care to recognize situations in which the assignable cost, developed using the prepayment credits, might be less than the minimum funding requirement. This could occur if prepayment credits are adjusted at an effective interest rate greater than that used for adjusting the credit balances. Nevertheless, if the scheme of parallel CAS calculations is replaced with fully harmonizing assignable costs with ERISA minimum funding requirements, then ERISA credit balances will be taken into account by default.

(d) To what extent, if any, should revisions to CAS be based on the measurement and assignment methods of the PPA?

Full harmonization would appear to require at least the permitted usage of similar or identical asset valuation methods, liability valuation methods, assumptions and amortization periods. Of these, only the PPA asset valuation methods and the liability valuation method for non-pay-related formulas would be permissible under *current CAS rules. Of particular concern is the disconnect between the seven-year amortization period of unfunded liabilities mandated by PPA and the amortization periods permitted under the current CAS rules., Also of concern is the disconnect between the interest rate assumption mandated by PPA for valuing liabilities and the requirement under current CAS rules that the interest rate, as is the case of all assumptions, "reflect long-term trends so as to avoid distortions caused be short-term fluctuations."*

Yet another concern is much more practical. If the CAS are the only regulatory environment that permits use of certain cost methods, such as the entry-age normal method, it becomes increasingly unlikely that valuation software will continue to be properly maintained to fully support such methods. In addition, it will also become less likely that future actuaries will be fully familiar with these methods. While this situation may only develop over the long term, the current CAS rules have been in effect largely unchanged for over 30 years. Over the next 30 years, most of today's practicing actuaries will have retired. Accordingly, it is appropriate to take this possibility into consideration when considering the extent that the CAS should be harmonized with the PPA.

(i) To what extent, if any, should the Board revise the CAS based on rules established to implement tax policy?

It should be recognized that contractors are required to comply with ERISA and tax laws and should be expected to behave in a rational manner that avoids any adverse repercussions of compliance. Instead of being tax driven, CAS rules are intended to address the consistent accounting of contractor costs. However, if they do not take into account the interrelation with tax laws, and presuming that the CAS Board continues to link allocability of pension costs to the funding of those costs, the CAS rules may force contractors to implement decisions contrary to maintaining a robust pension system in order to avoid the adverse consequences. For example, if the CAS rules do not (or only minimally) harmonize, employers may choose to terminate their pension plans in order to remain competitive with contractors who do not maintain defined benefit pension plans. Finally, it should be noted that the PPA was not tax-policy driven. Instead, the stated intent of the PPA is to "provide economic security for all Americans." In fact, to the extent the PPA increases pension plan contributions, it produces a reduction in tax revenues.

(ii) To what extent, if any, should the Board consider concerns with the solvency of either the pension plan, or the PBGC?

The solvency of a pension plan can directly affect the solvency of the sponsor maintaining the pension plan. If a contractor becomes financially weak or insolvent due to the solvency issues of its pension plan, it can affect the contractor's ability to fulfill the terms of its contract to the detriment of the government. Therefore, the Board should give some attention to plan solvency as part of the process needed to maintain a robust and competitive contracting environment.

4. Cost Measurement. CAS measures the accrued pension liability and pension cost on the "going concern" basis of accounting that assumes the contractor and pension plan will continue lacking evidence to the contrary. Conversely, PPA measurements are made on liquidation or settlement cost basis.

Question 4. (a) Accounting Basis. For Government contract costing purposes, should the Board (i) Retain the current "going concern" basis for the measurement and assignment of the contract cost for the period, or (ii) revise CAS 412 and 413 to measure and assign the period cost on the liquidation or settlement cost basis of accounting?

The measurement of pension costs in accordance with the PPA is largely consistent with current domestic and international financial accounting, as evidenced by U.S. financial accounting standards and International Accounting Standards for measuring pension costs of employers. Like the PPA, these standards dictate that pension costs be measured reflecting the yields of high-quality debt instruments of appropriate duration, which they define as an "ongoing basis." The accounting basis similar to that currently being used under CAS was replaced by FAS 87 in the United States approximately 20 years ago. While the accounting standards prescribed by FAS 87 are currently being revisited, with the expectation that some revisions may *be made, it is also expected that the fundamental approach to accounting for pensions on a marked-to-market basis will be retained.*

(b) Actuarial Assumptions. For contract cost measurement, should the Board (i) continue to utilize the current CAS requirements which incorporate the contractor's long-term best estimates of anticipated experience under the plan, or (ii) revise the CAS to include the PPA minimum required contribution criteria, which include interest rates based on current corporate bond yields, no recognition of future period salary growth, and use of a mortality table determined by the Secretary of the Treasury?

As discussed above, the current and widely accepted financial accounting viewpoint for measuring costs suggests that an approach similar to that imposed by the PPA is the preferred approach for the measurement of defined benefit costs (except as noted below). One significant assumption under financial accounting that deserves special mention is the use of an expected long-term rate of return on assets to account for investment performance separately. This assumption is intended to reflect the underlying asset portfolio and is selected independently from the discount rate used for valuing plan liabilities. It should be noted that the Financial Accounting Standards Board is currently reviewing and will most likely revise the manner in which financial accounting treats investment performance. Such revisions could include (1) determination of the expected return on assets using the same rate as used for discounting liabilities and/or (2) more rapid recognition of deviations in asset performance than is currently required.

The PPA implicitly treats asset performance that deviates from the effective interest rate used in determining liabilities as asset gains or losses to be amortized over a period of seven years. Accordingly, favorable or unfavorable investment performance is reflected in costs as it develops and is not anticipated in advance, as is the case under current CAS rules and, to a certain degree, under FAS 87.

(c) Specific Assumptions. Please comment on the following specific assumptions:

- (i) Interest Rate:
  - (1) For measuring the pension obligation, what basis for setting interest rate assumptions would best achieve uniformity and/or the matching of costs to benefits earned over the working career of plan participants?

Under both financial accounting and the PPA, the costs of benefits earned are calculated using assumptions consistent with investment-quality corporate bonds of appropriate duration. For financial accounting, which is intended to match costs to benefits, this approach is used as the best estimate of the cost of benefits for defined benefit pension plans. While it is understandable to be concerned with the variations in costs that may occur with the fluctuation in the interest rate environment, it should be recognized that interest rate fluctuations have an impact on asset values and other cost elements that may affect contract pricing. Accordingly, a broader view may indicate that the impact of interest rate fluctuations on pension costs serves to counterbalance opposite behavior of other contract cost elements, thereby reducing overall contract cost volatility.

  - (2) To what extent, if any, should the interest rate assumption reflect the contractor's investment policy and the investment mix of the pension fund?

There has been extensive discussion in recent years regarding the use of settlement-type rates (high-quality bonds). Almost universally, the resulting conclusions have been to use these types of rates. We believe that the Board would be better served by accepting these conclusions rather than reopening this debate once again.

Taking the cue from financial accounting, there may be some theoretical merit in using an independent assumption for asset performance that reflects the investment mix and investment policy of the pension fund. However, under harmonization approaches that more fully embrace the PPA methodology, such an assumption would have little or no impact on assignable costs in the current accounting period. Instead, it would seem to affect only projected costs in future accounting periods. Projected costs would seem to be more appropriate to address in the context of forward pricing and not harmonization with the PPA.

(ii) Salary Increases: For measuring the pension obligation, should the CAS exclude, permit or require recognition of future period salary increases?

Ongoing accounting under current financial accounting standards requires the recognition of future salary increases when assigning costs to the current accounting period. However, the appropriateness of this practice is currently being debated both in the United States and the United Kingdom.

Dropping the use of salary projections would improve consistency in the measurement of costs with the PPA and among contractors, since it would eliminate an assumption that typically varies by employer. However, it would fail to take into account the distinction between final-average-pay plans and career-average-pay plans.

If the CAS requires the recognition of future period salary increases, it would produce costs higher than those required under the PPA (which only requires recognition of the impact of salary growth in the current year). Accordingly, such recognition would appear to be in excess of the minimum changes needed to comply with Congress's mandate to harmonize the CAS with the PPA.

On the other hand, since future period salary increases are recognized under the PPA for purposes of determining maximum deductible amounts, we would anticipate that costs developed with methods and assumptions similar to those prescribed by the PPA, but anticipating future salary increases, would fall within the minimum and maximum amounts under the PPA.

Using a cost method that recognizes future salary increases produces costs that do not accelerate as rapidly as individual employees approach retirement. However, this recognition will have this effect on plan costs as a whole only if the employer's workforce is aging.

In addition, cost methods that recognize future salary increases tend to produce an adjustment of costs in favor of the government when benefits are curtailed due to plan termination or a segment closing. This occurs because a portion of the ongoing funding is attributable to the funding of anticipated future accruals, which are typically never realized in a curtailment situation.

(iii) Mortality: For measuring the pension obligation, should the CAS exclude, permit, or require use of a (1) Standardized mortality table, (2) company-specific mortality table, or (3) mortality table that reflects plan-specific or segment-specific experience?

The current CAS rules do not appear to be in conflict with the basis for establishing mortality assumptions under the PPA. Note that to justify a substitute mortality table, the proposed IRS regulations require at least 1,000 deaths by gender over no more than a four-year period. This avails these rules only to large employers. For example, with a group of males age 65, more than 130,000 lives (or 32,500 lives per year over 4 years) would be required to expect to generate 1,000 deaths.

(d) Period Assignment (Amortization). For contract cost measurement, should the Board (i) retain the current amortization provisions allowing amortization over 10 to 30 years (15 years for experience gains and losses), (ii) expand the range to 7 to 30 years for all sources including experience gains and losses, (iii) adopt a fixed 7 year period consistent with the PPA minimum required contribution computation, or (iv) adopt some other amortization provision?

The current amortization rules under CAS are a direct reflection of the permitted amortization periods when ERISA was initially adopted. Even though the ERISA amortization periods have been subsequently revised and now under the PPA have been uniformly changed to seven years, the CAS periods have remained unchanged since inception. Accordingly, there appears to be little or no foundation to justify requiring an amortization scheme that is inconsistent with the PPA minimum funding requirements. This might be accomplished by expanding the current permissible amortization periods to accommodate the seven-year period under the PPA. Alternatively, the Board may choose to require a uniform seven-year amortization period for all purposes. This latter approach would improve consistency in the measurement of costs among contractors.

(e) Asset Valuation.

(i) For contract cost measurement, should the Board restrict the corridor of acceptable actuarial asset values to the range specified in the PPA (90% to 110% of the market value)?

(ii) For contract cost measurement, should the Board adopt the PPA's two year averaging period for asset smoothing?

We believe that the asset valuation methods permitted under the PPA would be acceptable under the current CAS rules. Accordingly, we see little need for the Board to revise the current rules with respect to acceptable asset valuation methods. However, in the interest of simplicity and consistency, the Board may want to consider adopting the same rules that are permitted under PPA. However, even if the CAS were not amended to substantially replicate PPA funding, many contractors are likely to use a method compliant with the PPA.

5. At-risk Plans. For plans with a low level of funding, the PPA imposes certain provisions that may require higher "at-risk" minimum required contributions than is required for plans that do not have this low level of funding. The "at-risk" provisions are intended to more rapidly fund plans that are likely to fail due to underfunding and be taken over by the PBGC.

Question 5. To what extent, if any, should the Board revise the CAS to include special funding rules for "at-risk" plans?

The funding and benefit provisions that the PPA added regarding at-risk plans indicate a public policy concern about the security of benefits for participants covered by such plans, particularly with respect to benefits those participants have already accrued. Part of these special funding rules for "at-risk" plans requires the use of certain worst-case assumptions about when participants will retire and commence their benefits. While it may be appropriate to revise assumptions in the case of an at-risk plan to reflect revised employment expectations, use of worst-case assumptions is inconsistent with going concern accounting principles.

The Board could choose to support this policy position by allowing or requiring the special funding rules and assumptions that apply to at-risk plans in the harmonized CAS. Advantages of adopting this approach include:

- *Adoption of the PPAs at-risk assumptions would reduce or eliminate the possibility of disagreement between the contractor and the government over the appropriate CAS assumptions for an at-risk plan.*
- *Contractors with at-risk plans are often less solvent than their counterparts with healthier plans. Failure to adequately reflect these special funding rules would force such contractors to bear increased pension costs that are not assignable. Such a situation would increase the likelihood of the contractor becoming insolvent, compromising the contractor's ability to fulfill the requirements of its contracts.*
- *In the event that a contractor with an at-risk plan fails, the at-risk costs not assignable under CAS 412 probably would become assignable under CAS 413. This suggests that the CAS rules could either provide for slightly increased contributions under the provisions of CAS 412 or be faced with a large one-time adjustment under CAS 413.*
- *Besides requiring more aggressive funding in certain at-risk circumstances, the PPA rules also impose constraints on the payment and additional accrual of benefits. These constraints are likely to reduce the contractors' ability to attract and retain qualified employees able to best fulfill the contract terms and would not seem to be in the best interests of the government. Full reimbursement of the increased minimum required contribution — or even more aggressive funding — would help enable such contractors to achieve a more sound financial footing.*
- *When Congress instructed the Board to harmonize CAS 412 and 413 with the PPA minimum contribution amount, it made no distinction between at-risk plans versus other plans, thereby supporting the notion that whatever assumptions might apply for minimum purposes should likewise be used for CAS.*
- *While at-risk rules can cause greater volatility, Congress addressed this concern by phasing in the increases due to at-risk funding rules over five years.*

6. Cash Flow Considerations. The PPA may create a disincentive for government contractors to continue their defined benefit plans if the pattern of cash outlays for pension contributions are not matched by the reimbursements for pension costs under Government contracts. The mismatching of cash flows might occur for two distinct reasons: (i) The pension costs assigned to a particular cost accounting period in accordance with CAS may be substantially less than the minimum contributions required by ERISA, or (ii) incurred pension costs may dramatically exceed previously forecast costs due to plans emerging from full funding and/or experiencing unexpected adverse asset or demographic results.

Question 6. (a) To what extent, if any, should the measurement and assignment provisions of CAS 412 and 413 be revised to address contractor cash flow issues?

The cash-flow mismatch is the primary issue for harmonization to address, since the theoretical underpinnings of CAS 412 and 413 already recognize that pension costs contractors incur in fulfilling government contracts are assignable costs that are reimbursable by the government. CAS 412 and 413 simply set forth the manner in which these costs are assigned to accounting periods in which government contracting is performed. To the extent that this assignment is not consistent with the contractor's cash flows, it may produce borrowing needs by the contractor which could compromise the contractor's competitiveness and may reduce its ability to access cash that may be critical for the timely fulfillment of its contract requirements. In order to manage this, as described in our answer to question 3, contractors are likely to consider approaches to eliminate this competitive disadvantage.

Clearly, one such alternative is the termination of the contractor's pension plan, which would demand an immediate assignable cost adjustment under CAS 413 that is immediately adverse to the government. Another alternative is a change in the plan's investment strategy to minimize the risk of cash-flow mismatches, with the trade-off being reduced future investment returns. This alternative is likely to be adverse to the government in the long term due to less favorable emerging investment performance. Finally, some employers choose to cease competing for government business. This could reduce the pool of available contractors, which would result in reduced competition, slower responses to unforeseen needs, and ultimately increased government costs.

(b) To what extent, if any, do the current prepayment provisions mitigate contractor cash flow concerns?

In the current interest rate environment, multi-year forecasts of CAS assignable costs often show the development of very substantial and essentially permanent prepayment credits. Conceptually, these prepayment credits develop because, under current CAS rules, the funding target is determined using an interest rate that reflects anticipated investment returns. PPA rules, on the other hand, determine a funding target based on corporate bond yields. As long as long-term corporate bond yields are less than anticipated investment returns, the Board should expect prepayment credits to persist. This suggests that, absent changes in the CAS rules, the only way that a contractor can hope to be reimbursed for these costs is either through a revision of investment strategy to bring expected returns closer to corporate bond returns or through CAS 413 cost adjustments triggered by a plan termination.

(c) To what extent, if any, should the prepayment credit provision be revised to address the issue of potential negative cash flow?

Prepayment credits usually develop for one of two reasons: because the contractor is required to make contributions above the CAS assignable cost to satisfy minimum funding ("required prepayment *credits") or because the contractor chooses to make additional contributions for cash-flow purposes ("voluntary* prepayment *credits"). (Prepayment credits can also arise in segment closings when the segment is in a surplus position and the CAS 413 adjustment is settled outside the plan.) Required prepayment credits are likely to increase in magnitude and frequency under the PPA, at least until harmonization is achieved.*

Under the current rules, prepayment credits generally do not become assignable unless the contractor chooses to use a prepayment credit as funding for an assignable cost in lieu of contributing additional funds. However, this choice is not available in situations in which the minimum required contribution equals or *exceeds the assignable cost for the accounting period. To obtain harmonization, a systematic method for assigning these required prepayment credits would seem to be necessary. This might be accomplished by including an amortization of required prepayment credits as an additional component of the assignable cost. To ensure requiring amortization of these required prepayment credits, this component would need to be assignable even if the remaining assignable cost is zero.*

7. Volatility in Contract Cost Projections. The second potential source of cash flow mismatch is attributable not to the basic measurement and assignment provisions of the Standards, but to the volatility of contract costs for pensions and contribution requirements (see Question 5 above). The ”all or nothing" effects of the CAS 412 assignable cost limitation and the ceiling on assigned cost for income tax purposes could significantly impact the volatility of contract cost forecasts.

Question 7. (a)(i) To what extent, if any, would adoption of some or all of the PPA provisions impact the volatility of cost projections?

The topic of volatility in this context is fairly complex. While the desire for stable, non-fluctuating costs is understandable, we believe that unpredictability of costs is a much greater concern. The source of this unpredictability falls in several areas. One source of unpredictability is the unpredictability of investment returns. However, this source is not new to the PPA and has been the primary contributor to unstable contributions patterns under pre-PPA funding rules.

A second source is the unpredictability of corporate bond rates. While this source has been elevated to the forefront by the PPA by making it a central element in the determination of costs, the Deficit Reduction Contribution (DRC) calculations have used a similar basis for measuring liabilities since this aspect of ERISA was enacted. Making usage of these rates a fundamental requirement in determining pension contributions tends to produce pension costs that fluctuate more than would result with the use of a constant rate.

The final source of unpredictability is the disconnect that can occur between asset returns and changes in the liabilities due to changes in the effective interest rate for determining the liabilities. This can produce situations in which liability values rise while asset values fall, and vice versa, amplifying instead of dampening volatility.

One area in which PPA would seem to reduce volatility of pension costs is in the reduced applicability of the maximum deductible limits due to the increased level of allowable contributions. This should help to minimize when the contribution “on/off” switch controlled by the full funding limitation will apply.

(ii) Are there ways to mitigate this impact? Please explain.

Much of the perceived volatility can be traced directly to changes in the value of assets that are not mirrored by similar changes in the value of liabilities. This form of volatility can be mitigated through the appropriate use of liability-driven investments, which serve to produce asset returns that mirror the change in liabilities produced by fluctuations in prevailing interest rates. Such investments could include immunized portfolios, duration-matched portfolios, and duration-matched interest rate hedging strategies. Some of these strategies would require the contractor, as plan sponsor, to forego the prospect of future investment gains that otherwise might be used to offset or reduce assignable costs in future periods. In many circumstances, adoption of such strategies, whether or not the CAS rules are substantially changed to harmonize, are likely to produce anticipated future investment returns that are lower than those currently expected, absent a change in investment strategy.

Annuitization of some or all of the liabilities can also be used to eliminate future volatility. However, in the current annuity environment, annuitization is likely to produce actuarial losses that would not be immediately recoverable under current CAS rules. Instead, they would be amortized over 15 years. Accordingly, contractors may be reticent to use this approach.

This volatility can also be somewhat mitigated by revising the CAS to take advantage of the relatively wide range of acceptable contributions permitted under the PPA. One way to do this would be to develop *assignable costs even when plan assets exceed the PPA funding target. For example, in this situation the assignable cost might be target normal cost reduced by a seven-year amortization of the amount of overfunding.*

A more revolutionary approach to mitigate the impact of investment returns would be to revise the CAS rules to eliminate asset performance as a determinant of future CAS costs. One way to accomplish this would be to calculate the assignable cost as equal to the sum of three components. The first component would be the value of benefits accruing during the current accounting period (irrespective of actual asset performance.) The second component would be the amortization (e.g. seven years) of liability changes attributable to plan amendments and liability experience (except for changes due to changes in the effective interest rate.) The third component would be a transition amortization providing for the gradual recognition (e.g. seven years) of the initial difference between the value of assets and liabilities at the point the new rules become applicable.

Under this approach, the contractor would take full responsibility for future deviations in investment performance from returns that would be produced if the assets were fully immunized. All liability (or benefit) costs would continue to be assignable under the CAS. This would cause the contractor to be responsible for the adverse investment deviations but also be able to fully benefit from favorable deviation. From the government's perspective, such an approach would remove asset performance as one of the variables determining costs, thereby treating investment decisions as outside its purview.

From the contractor perspective, this approach is feasible only if sufficient financial instruments are available to actually create or approximate such an immunized approach. Otherwise, the contractor would be forced to underwrite a risk over which effective control cannot be accomplished. At the same time, we note that this is not the approach taken in determining the minimum contribution under PPA and would go beyond the congressional mandate for harmonization. In addition, compared to other harmonization approaches, it would be less supportive of the intent of the PPA to improve the security of pension plans.

The Board should also note that interest rate fluctuations, and hence any associated volatility, are dampened through the use of 24-month averaging in the determination of the rate segments. However, contractors who elect to use the bond yield curve must forego this use of 24-month averaging. While such an election might appear to increase volatility, under proper circumstances, it can enhance the ability of the contractor to match investment performance with changes in the liability due to interest rate fluctuations. As discussed above, this matching will reduce contribution volatility.

Another approach that might be used to mitigate the impact of the interest rate fluctuations is to somehow reflect economic price adjustments in the determination of assignable costs, similar to those used for oil and steel in certain fixed-price contracts. These adjustments could be linked to changes in the interest rate yield curve published by the IRS for PPA purposes. While this approach would do little for the assignment of costs in the current period, it could be helpful in avoiding winners and losers in future accounting periods that might arise solely due to interest rate fluctuations. However, we recognize that economic price adjustments are currently addressed in the FAR and only apply to fixed-price contracts. Accordingly, such an approach may be beyond the realistic scope of the PPA harmonization process.

(b) To what extent, if any, should the CAS assignable cost limitation be revised as part of the efforts to harmonize the CAS with the PPA?

Currently the CAS assignable cost limitation represents the point at which the asset level is deemed sufficient to obviate the need for additional contributions in the current accounting period as measured by the accrued liability under the actuarial cost method being used. In defining this limitation, the CAS rules mirrored the full funding limitation under ERISA, over which contributions were not deductible. Subsequent amendments to ERISA have modified the full-funding limit and the deductibility of contributions. With the passage of the PPA, the concept of linking the deductibility of contributions to this full-funding limit has been supplanted by a new measure which approximately equals the sum of 50 percent of the minimum funding target plus the projected unit accrued liability (reflecting projected salary growth and projected non-salary related benefit increases in future periods) plus the minimum funding target normal cost. This increased limit *suggests that Congress realizes that funding targets in excess of the minimum required funding level are appropriate in some situations.*

Because of this new paradigm, it is likely that the whole concept of the assignable cost limitation needs to be reevaluated as to its purpose. The most appropriate approach could depend heavily on the approach generally taken in harmonization.

A simple approach reflective of the PPA would be to set the assignable cost limitation equal to the maximum deductible contribution under the PPA. If the CAS assignable cost limitation is revised in this manner, it should greatly reduce the number of situations in which the assignable cost limit will unexpectedly limit the assignable cost to zero. The result is likely to be reduced volatility and enhanced predictability. In addition, it would be consistent with measurements for tax purposes, making it easily developed and easily audited.

Another approach that might have merit is to set the assignable cost limitation equal to the PPA minimum required contribution. While this is easy to apply, as alluded to above, it is likely to produce more volatile costs since it would set up a paradigm in which the assignable cost could never exceed the minimum required contribution. It would thereby eliminate a number of approaches that might be used to mitigate volatility. Further, permitting credit balances to play a role in determining assignable costs under CAS 412 must be considered carefully.

Yet another approach to consider is to define the assignable cost limitation in terms of the accrued liability under the projected unit credit cost method. Under this approach, it might be appropriate to recognize both future salary increases and future escalation in non-salary related benefits, as is permitted in the determination of the maximum deductible contribution under the PPA. This approach might provide a reasonable balance, falling between two alternatives discussed above, and would be based on components that contractors would already have to develop for PPA purposes.

(c) To what extent, if any, should the CAS be revised to address negative pension costs in the context of cost volatility?

Generally, the concept of negative pension costs is incompatible with the government's historical emphasis on funding, as well as the provisions of ERISA and the tax code preventing the withdrawal of funds from a qualified plan before the satisfaction of all liabilities. Theoretically, negative pension costs might be considered if a contractor's plan covers several segments, some being overfunded and some being underfunded. In this situation, it is conceivable that negative pension costs in the overfunded segment might be used to satisfy the assignable costs of the underfunded segment, provided that in aggregate a negative cost for the plan as a whole does not result. However, the cost reallocations would have direct impact on current and future pricing, would create cost shifting among contracts, and may create cost shifting among government agencies. Accordingly, it is very unlikely to produce an equitable result that acceptable for CAS purposes.

8. Segment Closings, Plan Terminations, and Benefit Curtailments.
Under the PPA, if a plan is determined to be severely ”at-risk,'' the further accrual of benefits is prohibited. Under CAS 413, such a cessation of accrual would be a curtailment of benefits. Currently, if the contractor retains pension assets and liabilities subsequent to the curtailment of benefits, CAS 413-50(c)(12) requires that the actuarial liability be measured using the assumptions that have historically been used to fund the plan. If the liability is transferred to an insurance company or the PBGC, the insurance premium or PBGC valuation of the liability determines the segment closing liability. The cost of the insurance premium and the liability assumed by the PBGC may exceed the PPA target liability and the actuarial liability measured by CAS 413-50(c)(12) because of the addition of the ”risk premium'' against adverse experience assessed by insurers.

Question 8. (a) To what extent, if any, would adoption of some or all of the PPA provisions affect the measurement of a segment closing adjustment in accordance with CAS 413.50(c)(12)?

Full harmonization of CAS 412 rules to the PPA would greatly reduce segment closing adjustment amounts under CAS 413 since assets and liabilities are annually being adjusted to reflect emerging market conditions. However, upon a segment closing it should be expected that there will be differences between the PPA funding target and the plan assets that would still need to be accounted for. Furthermore, while the assumptions mandated by the PPA are more representative of settlement rates, contractors who do not elect to use the bond yield curve must determine their liabilities using rates that are averaged over a 24 month period. These rates may not reflect market conditions at the time of a segment closing event. In addition, it should continue to be anticipated that the cost of annuity purchases or other settlement approaches will not be fully captured through use of the PPA funding assumptions.

Finally, the continued appropriateness of the requirement that the assumptions be consistent with current and long-term assumptions would seem to need review. It should be noted that when the segment closing adjustment is based on assumptions different from those used for determining ongoing costs, the adjustment reflects a "true-up" of prior costs and likely represents the final opportunity for the CAS costs associated with the segment to be harmonized with the PPA. To harmonize this true-up, the adjustments should be calculated using assumptions consistent with the PPA and should not reflect anticipation of future investment performance.

(b) To what extent, if any, should the CAS 413 criteria for a curtailment of benefits be modified to address the PPA mandatory cessation of benefit accruals for an "at-risk'' plan?

Unless CAS 413-50(c)(12) is amended, cessation of benefit accruals resulting from a funding target attainment percentage of less than 60 percent would appear to represent a curtailment and, as such, trigger a segment-closing adjustment. This would seem inconsistent with the purpose of these provisions, since accruals would normally resume when the funding percentage equals or exceeds 60 percent and the associated CAS 413 adjustment would provide a source of funds to immediately inject into the plan to achieve this funding level. In any event, harmonization of the CAS 412 rules with the PPA should greatly reduce situations in which contractor plans could experience funding deterioration to an extent that would cause the cessation of benefit accruals.

9. Technical Issues. The PPA changes the ERISA provisions for (a) Treatment of credit (carryover and prefunding) balances (analogous to "prepayment credits'' under the CAS), (b) treatment of contributions made after the end of the plan year, and (c) recognition of collectively bargained benefits.

CAS 412 requires prepayment credits to be adjusted at the valuation rate of interest (the CAS valuation rate) while the PPA requires credit balances to be adjusted based on the pension fund's actual rate of "return on plan assets.'' CAS 412 and 413 do not contain specific language on the treatment of contributions made after the end of the plan year, while the PPA requires that such contributions to be discounted at the PPA "effective interest rate.'' CAS 412 recognizes only the benefits specified in existing collective bargaining agreements, while the PPA recognizes anticipated changes in benefits based on established patterns.

Question 9. (a) Prepayment Credits. Should prepayment credits be adjusted based on the CAS valuation rate or the PPA requirement to use the pension fund's actual "return on plan assets'' for the period?

As alluded to in our response to question (6)(c), we believe that the prepayment credits have different characteristics depending on whether they have developed because the contractor was required to make contributions above the CAS assignable cost to satisfy minimum funding or because the contractor has chosen to make additional contributions for other purposes.

When a contractor chooses to make additional contributions, such contributions would produce funding standard account credit balances under the PPA that are adjusted with the pension fund's actual return on plan assets. To do otherwise for CAS purposes would require the contractor to account for these costs in two ways, one for ERISA funding purposes and one for CAS purposes. This requirement would seem to produce unneeded complexity without a clear benefit to either the government or the contractor. In addition, these contributions would appear to be financing decisions by the contractor. Accordingly, it is unclear why it might *be appropriate for the government to assume the investment risk associated with these advanced contributions before they become assignable costs.*

The situation when a contractor is required to make contributions above the CAS assignable cost to satisfy minimum funding could arise only to the extent that harmonization fails to permit the full and immediate assignment of minimum required contributions. Under this situation, it would appear more appropriate for the investment risk associated with the prepayment credits to be assumed by the government, starting when the contribution is made. Because we are uncertain how such harmonization would be implemented, it is difficult to theorize how this would best be accomplished.

(b) Contributions Made After End of Plan Year. Should the interest adjustment for contributions made after the end of the plan year be computed as if the deposit was made on the last day of the plan year or on the actual deposit as now required by the PPA?

The current CAS rules are silent on the method in which interest adjustments should be made. Accordingly, it would appear that the application of interest adjustments by contractors would be part of their established accounting practices. Under the current rule, treating contributions made after, but within 8-1/2 months of, the close of the plan year, allows contractors to maintain consistency between CAS and ERISA cost calculations. If the harmonized CAS rules mirror the PPA changes in determining interest adjustment for payments made after the close of the year, or continue to permit the determination of such interest adjustments as part of a contractor's accounting practice, it would enhance the continued consistency between CAS and ERISA cost calculations. Conversely, not permitting such interest rate adjustments would create an area where inconsistencies could occur. Finally, it should be noted that under FAR 31.205-6(j)(2)(iii) interest adjustments for contributions made 30 days beyond their due dates are unallowable and hence would not be assignable.

(c) Collectively Bargained Benefits. (i) To what extent, if any, should the CAS be revised to address the PPA provision that allows the recognition of established patterns of collectively bargained benefits?

Under the PPA, recognition of established patterns of collectively bargained benefits is exclusively associated with the determination of maximum deductible limits. This recognition is analogous to the recognition of future period salary increases when determining the maximum deductible contribution. If the CAS rules fail to recognize established patterns of collectively bargained benefits in determining the assignable cost limit, situations could arise in which the assignable cost limit would differ from the maximum deductible limit. Such a difference would seem to serve little purpose other than introducing unneeded complexity.

(ii) Are there criteria that should be considered in determining what constitutes an established pattern of such changes?

For determining the maximum deductible limit, the PPA limits the expected rate of increase to the average annual rate over the preceding six years. For purposes of determining the assignable cost limit, there would seem to be little or no benefit of diverging from this approach.

10. Available Data on Costs under CAS vs. PPA. To fully examine the relationship of the measurement and assignment of contract costs for pensions, the minimum required contribution, and the maximum tax-deductible contribution, the Board believes that data considering many different scenarios would be very informative and enhance its deliberations.

Question 10. The Board would be very interested in obtaining the results of any studies or surveys that examine the pension cost determined in accordance with the CAS and the PPA minimum required contributions and maximum tax-deductible contribution.

The Cost Accounting Standards Task Force and the Pension Committee hope to undertake a survey of government contractors to gather information to assist in evaluating the difference between current CAS assignable costs and PPA minimum contributions. In order to maintain the confidentiality of the information, it *is intended that the data be submitted normalized to the PPA unit-credit accrued liability, assuming a standardized effective interest rate. All other values would be presented as percentages of the accrued liability. This approach should provide information as to the impact of PPA on a wide variety of contractors, but will not differentiate among the various sizes of the contractors. Accordingly, information concerning the absolute magnitude of the impact can not be determined.*

11. Records and Visibility. Beginning in 2008, actuarial valuation reports prepared for ERISA and financial accounting purposes will no longer be required to include the accrued actuarial liability and normal cost measured under cost methods and assumptions that comply with the provisions of CAS 412 and 413. Actuaries and valuation software could still produce such values, and such valuation results would still be subject to the Actuarial Standards of Practice.

Question 11. In light of the changes to the PPA, should the Board consider including specific requirements in CAS 412 and 413 regarding the records required to support the contractor's proposed and/or claimed pension cost?

Actuarial Standard of Practice No. 41 addresses the appropriate information to be provided in actuarial communications, including actuarial reports. It is expected that adherence to this standard should satisfy the requirements needed to support the contractor's claimed costs. Even currently, significant differences exist between the CAS rules and ERISA funding. Accordingly, it would generally be expected that a separate report prepared in accordance with ASOP No. 41 addressing CAS assignable costs is currently required.

The members of the Academy's Cost Accounting Standards Task Force appreciate this opportunity to share our thoughts on this issue. If we can answer any further questions or otherwise be of assistance, please contact Samuel Genson, the Academy's Pension Policy Analyst, at (202) 223-8196.

Sincerely,

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