03 Defense Actuaries Group
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November 3, 2008

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

Re: CAS- Pension Harmonization ANPRM

This letter represents our response to the Advance Notice of Proposed Rulemaking (ANPRM) issued on September 2, 2008 by the Cost Accounting Standards (CAS) Board (CASB) pertaining to the harmonization of CAS 412 and 413 with the Pension Protection Act of 2006 (PPA).

At the outset, we commend the CASB for the thorough and thoughtful effort that went into drafting the ANPRM. We were especially pleased that so many of the suggestions our group made in our response to the CASB Staff Discussion Paper were incorporated into the current proposal. In addition, we appreciate the creativity that led to some of the novel elements in the ANPRM, such as the five year amortization of mandatory prepayment credits.

Although the ANPRM does not establish as much commonality between the building blocks underlying the CAS cost and ERISA[1] minimum funding requirements as we would have preferred, the explanation of the Board's reasoning was quite helpful. In our view, the ANPRM provides a reasonable framework for the necessary revisions to CAS 412 and 413. Although this letter makes a number of suggestions, these comments address specific issues in the ANPRM and do not seek fundamental change to the approach set forth in the ANPRM. To mimimize duplication with others, our comments are limited to actuarial/technical issues.

Prepayment Credits

Our first comments pertain to the manner in which prepayment credits are treated under the ANPRM. Although we believe that we understand the objectives of the CASB pertaining to prepayment credits, we do not believe that the proposed regulation, as

[1] "ERISA" stands for the Employee Retirement Income Security Act of 1974. PPA amended the previous ERISA minimum funding requirements.

written, fully accomplishes those goals. The following paragraphs explain the basis for this assertion and the revisions that we feel would accomplish the CASB's objectives.

The Problem

The problems we noted arise when a contractor funds ahead of schedule (i.e., makes prepayments). Our starting premise – which we understand to be consistent with CASB goals – is that two otherwise identical contractors should have identical patterns of cost recovery if the only difference between the contractors is that one funds ahead of schedule while the other makes contributions only when required to do so by either ERISA (to satisfy minimum funding requirements) or CAS (to ensure that costs assigned to a period do not become unallowable).

The attached illustration compares two years of results for the identical contractors, A and B, except that A is assumed to fund $2,000 in each year and B is assumed to fund $4,000 in year 1 and $0 in year 2 (see line 13). For simplicity, interest is ignored (the remaining assumptions are shown in lines 4-12 of the attachment). As we understand the CASB's objective, A and B should each be in the same position from a CAS 412/413 perspective at the end of year 2. The problem is this: as shown in the "ANPRM Calculations" section of the attachment (lines 15-35), these two contractors would not, in fact, receive identical treatment under the ANPRM:

- Cost recovery differences: During the first two years, contractor A recovers $3,460 (cell I35) while contractor B recovers only $3,400 (cell O35).

- Prepayment differences: At the end of two years, contractor A has $540 of mandatory prepayment credits (cell G25) while contractor B has none (cell M25). However, contractor B has $600 of voluntary prepayment credits (cell M30) but contractor A has none (cell G30).

Thus, solely on account of funding earlier than contractor A, contractor B would be penalized twice under the terms of the ANPRM: once through reduced actual recovery and again through having voluntary prepayment credits that are less valuable than contractor A's mandatory prepayment credits.

Analysis

Our analysis identified two technical issues that resulted in the differential described in the preceding paragraphs. The first issue is that the ANPRM defines the mandatory prepayment credit as the excess of the "minimum required funding" over the CAS 412 cost. In turn, the ANPRM defines "minimum required funding" as the minimum ERISA funding requirement "reduced by any prefunding credits (e.g., credit balances, …" The basic problem here is that amounts of excess funding in a prior year impact the minimum required funding after reduction for prefunding credits but not the CAS 412 cost, thus yielding an "apples to oranges" comparison. This problem is easy to correct:

the comparison should be made using the minimum required funding before reduction for prefunding credits.

The second problem is more conceptual and concerns the nature of "voluntary prepayment credits." As drafted, the ANPRM contemplates a one-time classification of prepayments between "mandatory" and "voluntary." Because prepayments represent timing differences only, we believe that the ANPRM "voluntary prepayment" concept requires revision to achieve the CASB's goals. The easiest solution to this problem, in our view, is for CAS 412 to retain the present prepayment credit structure (we refer to these as "standard prepayments" to distinguish them from the ANPRM's voluntary prepayment credits) but to permit certain amounts of these standard prepayment credits to qualify for the favorable treatment described in the ANPRM by being reclassified as "mandatory prepayments."

The lines under "Suggested Calculations" of the attachment (lines 37-58) illustrate how these two changes would affect the calculations. The following aspects of these calculations should be noted:

- Identical results: At the outset, note that for each contractor, the amounts of cost recovery (line 58), standard prepayments at the end of year 2 (cells G47 and M47) and mandatory prepayment credits at the end of year 2 (cells G53 and M53) are identical. Thus, our suggested treatment yields the same treatment for contractors A and B (these results are also identical to those obtained for contractor A under the "ANPRM Calculations" discussed above).

- Impact of using minimum required funding before reduction: By redefining "minimum required funding" to be before any reduction for prefunding credits, the results of the calculation at cell M41 is corrected to conform to that in cell G41 (these amounts can be contrasted to the ANPRM calculations in cells G19 and M19).

- Impact of transfer from standard to mandatory prepayment status: By permitting standard prepayments to be reclassified as mandatory prepayments when the minimum required funding exceeds the CAS costs, the calculation in cells M46 and M50 yield the same results as those in cells G46 and G50.

In summary, by making the two corrections to the ANPRM as described above, the prepayment calculation will yield the same results for similarly-situated contractors where one funds more rapidly than the other, and will ensure that the CAS will not serve to inadvertently discourage pension funding. Without these corrections, the ANPRM would effectively penalize "good corporate citizens" (i.e., those who fund early, thus enhancing the retirement security of their participants) and reward procrastinators (i.e., those who wait as long as possible to make contributions and thus maximize the amount of "minimum required funding" as defined in the ANPRM).

At Transition: Determining Mandatory Prepayment Credits

Conceptually, mandatory prepayment credits represent the cumulative, interest-adjusted excess of ERISA minimum required funding amounts over CAS pension costs. In equation form, this means:

Mandatory Prepayment Credits = ERISA Minimum Requirements - CAS Costs

While easily measured for periods following the effective date of the harmonized CAS 412/413, a key transitional question concerns the initial amount of these mandatory prepayment credits, as historical records of the ERISA and CAS costs may be difficult to recreate. As explained below, however, the amount of mandatory prepayment credits at transition can, as a general matter, be derived from other records that are readily available.

At the time of transition, existing CAS prepayment credits (PPCs) equal a contractor's cumulative, interest-adjusted contributions in excess of CAS costs. Similarly, pre-PPA ERISA credit balances (CBs) equal cumulative, interest-adjusted contributions in excess of the ERISA minimum.[2] Stated algebraically, these two equations are:

CAS PPCs = Contributions - CAS Costs
ERISA CBs = Contributions - ERISA Minimum Requirements

By subtracting the second equation from the first, we get:

ERISA Minimum Requirements - CAS Costs = CAS PPCs - ERISA CBs

The left side of the preceding equation is the same as the right side of the first equation in this section; by substituting, this means that the mandatory prepayment credits at transition may be calculated as:

Mandatory Prepayment Credits = CAS PPCs - ERISA CBs

The excess, if any, of the CAS PPCs at transition over the mandatory prepayment credits would equal the voluntary prepayment credit. Alternatively, based on our proposal discussed above, the mandatory prepayment credit determined at transition would be transferred from the standard prepayment credit account to the mandatory prepayment account.

An assumption underlying the preceding equations is that CAS prepayment credits and pre-PPA ERISA credit balances are affected solely by calculations of ERISA minimum required funding amounts and pension costs under CAS 412/413. While generally true,

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[2] As discussed below, adjustments may be required to account for any periods between the effective date of PPA for a contractor and the effective date of the harmonized CAS.

there are factors that can affect either the CAS or ERISA calculation – but not both – that must be considered in developing the amount of the mandatory prepayment credit at transition. We have identified two situations that require special attention.

The first situation entails segment closings that occur prior to the harmonization effective date. In some cases, prepayment credits are created in the course of accounting for a segment closing.[3] In these cases, our analysis indicates that the preceding formula for determining the amount of mandatory prepayment credits at transition yields the proper result.[4] In cases where a deficit is present at segment closing, however, a mechanical application of the preceding formula may yield an amount of mandatory prepayment credits that would be less than zero. For that reason, it is important that the regulation define the mandatory prepayment credits at transition as the excess, <u>if any</u>, of prepayment credits determined under the pre-harmonized CAS over the ERISA prefunding balance on that date.

The second situation requiring special attention concerns the PPA rules that permit pension plan sponsors to "waive" a portion of their ERISA prefunding balance. To address this issue, we recommend that contractors be permitted to establish the amount of transitional mandatory prepayment credits as of any valuation date between (a) the effective date of PPA for the plan through (b) the effective date of the harmonized CAS, provided that the date selected is prior to any year where any ERISA prefunding balances were waived. Any mandatory prepayment credits established prior to the effective date of the revised CAS 412/413 would be carried forward (i.e., adjusted for actual CAS costs, minimum required funding amounts and interest at the long-term rate[5]) to the harmonized-CAS effective date. We believe that the contractor should be permitted to first apply prepayment credits not classified as "mandatory" to fund pension costs during the period prior to the effective date of harmonized CAS 412/413. If our suggested revision to the "minimum required funding" definition is accepted, waivers of prefunding balances after the effective date of the CAS harmonization rule will have no impact and need not be considered in the final rule.

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[3] Consider a contractor that closes a segment with a $100 pension surplus. If the contractor retains the segment's pension assets and liabilities and settles any amount owed to the Government with corporate funds, the plan will have a $100 prepayment credit. That is because (a) previously-determined CAS pension costs are adjusted downwards by $100 but (b) there is no net cash flow to/from the pension plan.

[4] For the sake of brevity, this letter does not include this analysis. If the CASB staff has difficulty replicating this result, we urge them to contact John McQuade for details of our analysis.

[5] Because pre-effective date interest on these transitional mandatory prepayment credits represents interest on a sub-account within the pre-harmonized prepayment credit account, the interest rate set forth in current CAS 412-50(a)(4) must govern.

Allocation of Mandatory Prepayment Adjustments to Segments

We believe clarification may be helpful concerning the allocation of mandatory prepayment adjustments to segments. Section 413-50(c)(1)(iii) of the ANPRM indicates that mandatory prepayment adjustments are to be allocated to segments using “a base that is representative of the factors … as described in 9904.413-50(c)(1).” While such an allocation makes sense for plans that use composite accounting, that approach may be inappropriate for plans that use segment accounting. That is because the funding status of the various segments may differ; because the less well-funded segments presumably accounted for a disproportionate share of the PPA/CAS differential, it would seem reasonable to likewise allocate a greater portion of the mandatory prepayment adjustment to the more poorly-funded segments. Specifically, we recommend that mandatory prepayment adjustments be allocated in proportion to the assignable cost limitation (ACL). In addition, because it is theoretically possible that mandatory prepayment adjustments may remain after all segments attain an ACL of zero, we recommend that any residual amounts be allocated in proportion to the liabilities of the segments.

Interest on mandatory prepayment credits

For the reasons set forth above, it will be necessary for prepayment credits to be transferred from “standard” to “mandatory” status to achieve the CASB’s goals. For this reason, it is highly desirable for both types of prepayments to be credited with the same rate of interest. As drafted, however, the ANPRM proposes that the mandatory prepayment credit be adjusted at the assumed long-term rate of return while voluntary prepayment credits would be adjusted based upon the actual return of the fund. If the long-term rate is selected, mandatory prepayment charges would not require recalculation each year, which would be beneficial from an administrative and predictability perspective. On the other hand, use of the actual rate of return would eliminate distortions. As a group, although we feel that the same rate must apply to both types of prepayments, we do not have a consensus as to which of the two rates represents the best choice.[6]

[6] In our response to the Staff Discussion Paper, we noted a preference to adjust prepayment credits using the actual rate of return in lieu of the long-term rate, thereby (a) ensuring fairness to both parties and (b) better harmonizing CAS 412/413 with PPA. At that time, of course, we had not considered the impact of mandatory prepayment credits.

Components of pension cost: clarification

Because CAS 412/413 are, of necessity, becoming increasingly complicated, we believe that it would be useful to state explicitly, probably at CAS 412-40(b)(3), that any mandatory prepayment charges that are separately allocated to cost objectives of a period do not represent components of assignable CAS pension costs. In addition, illustrations might be useful to clarify that mandatory prepayment charges are not included in the CAS assignable costs that are compared with the minimum required funding amount under ERISA for purposes of determining mandatory prepayment credits, are not subject to funding requirements, etc.

We further suggest that the illustration at ANPRM section 412-60(c)(17) be expanded by adding the following sentence: “The total amount to be allocated to cost objectives is $606,554, which equals the sum of (a) the assigned pension cost of $600,000 plus (b) the mandatory prepayment adjustment of $6,554.”

Minimum Actuarial Liability

Assumptions

The ANPRM contemplates that the assumptions that would satisfy the terms of either (a) Statement of Financial Accounting Standards No. 87 (FAS 87) or (b) PPA (in both cases, based upon current rules) could be used to compute the minimum actuarial liability (MAL). While both FAS 87 and PPA require the use of current “spot” rates, we also recommend that contractors be permitted to calculate the MAL using a long-term expectation of high-quality bond yields, thereby enhancing predictability. Finally, we suggest that the CASB clarify that a single interest rate is contemplated for a pension plan, thereby eliminating the potential need to determine interest rates that might vary by segment. To minimize the potential for disputes, we suggest that illustrations be added addressing each of these points.

Testing AAL versus MAL

The ANPRM proposes, at section 412-40(b)(3)(i), that the actuarial accrued liability (AAL) be adjusted when “the minimum actuarial liability exceeds the actuarial accrued liability.” Consider the following example:

	Liability	Normal Cost	Total
AAL assumptions	$100	$10	$110
MAL assumptions	95	20	115

Based on the ANPRM, the MAL assumptions would not be used for this year because the MAL of $95 is less than the AAL of $100. However, because the $115 sum of the

MAL and the minimum normal cost exceeds the corresponding amount of $110 on an AAL basis – which thus indicates that the appropriate end-of-year theoretical funding goal should be $115 – the Board's intent would seem to be better implemented if the test at 412-40(b)(3)(i) was based upon the liabilities plus the normal costs for the year. This could be accomplished by modifying the relevant language to read: "... the minimum actuarial liability (including minimum normal cost) exceeds the actuarial accrued liability (including normal cost)."

Assignable Cost Limitation

It is our understanding that multiplying the AAL by 125% in determining the ACL is intended to add a cushion based on long-term funding. We also understand that multiplying the greater of the AAL and the MAL by 125% could, in some situations, result in a cushion that might be inappropriate from a policy perspective. At the same time, however, we feel that it would be inappropriate from a theoretical perspective for the ACL to limit costs in a manner that would preclude full funding on a settlement basis. Accordingly, we recommend that the ACL be calculated using liabilities/normal costs equal to the greater of (a) 125% of the AAL plus 100% of the normal cost and (b) 100% of the MAL plus 100% of the minimum normal cost.

Funding Hierarchy

ANPRB section 412-50(a)(4) contains the following hierarchy of pension funding:

1. Current contributions up to the minimum required funding amount;[7]
2. Mandatory prepayment credits;
3. Voluntary prepayment credits; and
4. Current contributions in excess of the minimum required funding amount.

Although we have no particular concern with this hierarchical approach, and we understand the need for a hierarchy with regard to mandatory prepayment credits, we do have a concern with the required order of items 3. and 4. Specifically, given the lack of explanation in the ANPRM, and past experience at one Government agency, we are concerned that CASB may be attempting to eliminate – with no discussion – quarterly interest adjustments that have long been considered allowable costs on contracts with the DoD and other agencies.

As background, the Centers for Medicare & Medicaid (CMS), working jointly with the Department of Health & Human Services Office of Inspector General (OIG), has historically asserted that any prepayment credits existing at the beginning of a plan year must be applied on the first day of the plan year to fund pension costs, thereby

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[7] For the reasons explained above, we propose to amend the definition of "minimum required funding." This proposal, if accepted, would impact the CASB's intent with regard to funding hierarchy. However, this is easily addressed by specifying, in section 412-50(a)(4), that the minimum required funding would be reduced by prefunding credits.

eliminating (in their view) the interest adjustment for quarterly funding.[8] In our view, such a result – if this is indeed what the CASB is proposing – would be inequitable and inconsistent with decades of practice for DoD contractors.

The issue is most easily explained with an example. Suppose there are no prepayment credits, that the pension cost for a year is measured to be $1,000 as of the first day of the year, that pension costs are presumed to be funded quarterly in accordance with the FAR schedule, and that the valuation interest rate is 8.50%. All parties would agree that the CAS pension cost for the year, adjusted for interest, would be determined as follows:

$$\begin{aligned}\text{CAS Pension Cost} &= \$1{,}000 \times \left(1 + \frac{8.5}{12} \times 8.50\%\right) \\ &= \$1{,}060\end{aligned}$$

The pension cost of $1,060 would be allocated as an allowable cost to contracts, thereby permitting the contractor to recover $1,060 through progress payments during the course of the year. Now suppose that the contractor funded $1,000 on the last day of the preceding plan year, thereby creating a prepayment credit of $1,000 on the first day of the current plan year. The approach that CMS/OIG has advocated in the past is this: the CAS cost would be limited to $1,000, which means that the contractor could now only recover $1,000 during the year through progress payments. In essence, this means that the contractor would be forced to provide the Government with an interest-free loan from the beginning of the plan year (when the contractor makes the contribution) to the dates when pension costs are recovered through progress payments.

To resolve this problem, we recommend that the funding hierarchy be limited to the first two elements listed above. Alternatively, we recommend that CAS 412 state explicitly that interest based on presumed funding in accordance with the schedule contained in the FAR shall be considered to be a component of pension cost. Under this scenario, however, we note that a number of changes to CAS 412/413 would be required that would be unrelated to harmonization.

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8 See, for example, http://oig.hhs.gov/oas/reports/region7/70600209.pdf. Note that the contractor's response starting on page 35 of the pdf addresses this issue as it had been set forth in a draft audit report and the Government's response starting on page 15 of the pdf.

Segment Closings

The transition rules at ANPRM section 413-64.1(c) provide that the MAL is to be phased-in over five years for segment closing purposes. Given that the premise of segment closing adjustments is that prior-period costs must be trued-up because there are no future periods in which to make adjustments, it does not make sense to us to have a phase-in rule where there is a final settlement. Because this phase-in does not apply to plan terminations, such a rule may encourage contractors to engage in more expensive terminations as a means of avoiding the phase-in. To correct this problem, we recommend that the phase-in be eliminated for segment closing calculations.

Consistent with our earlier recommendation, the Board has provided that any temporary cessations of benefit accruals that may be required by PPA will not be deemed to be "curtailments" under CAS 413. Because curtailments must be revisited in any event to achieve harmonization, we encourage the CASB to abandon the curtailment concept in its entirety, given the ongoing nature of the contractual relationship between the parties. Alternatively, the CASB should consider whether or not current agency guidance,[9] which requires contractors to compute ongoing pension costs under CAS 412/413 for periods following a curtailment, meets the requirements of CAS 413.

Transition

In our view, there would be significant advantages to both contractors and the Government if contractors were permitted to harmonize their CAS asset smoothing methodology to match their PPA method without that change being deemed a voluntary change in cost accounting practice. This approach would reduce administrative costs by contractors, would simplify future audits and would be consistent with the PPA requirement to harmonize CAS 412/413 with the PPA minimum required contribution. In addition, this would simplify contract and administration with respect to contractors that are considering announcing soon that they intend to modify their asset smoothing formula, effective January 1, 2011, to be the same as their PPA method.

As a general rule, we feel that the transition rules require additional thinking, and suggest that the Board carefully consider alternative transition approaches in the time leading up to the publication of a Notice of Proposed Rulemaking (NPRM). In particular, we are concerned that the transition rules are exceedingly complex. In our experience, this level of complexity will inevitably lead to increased disputes and the associated administrative costs. We understand that this is not an easy issue and would be willing

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[9] See "Joint DCMA / DCAA Policy On Defined Benefit Plan Curtailments" dated August 2007.

to meet with the CASB or staff in an attempt to identify approaches that yield acceptable results to all parties.

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We appreciate the opportunity to comment on the ANPRM. Due to the complexity of the issues and today's deadline to file comments, this letter summarizes the results of our analysis to date. To provide interested parties with sufficient time to analyze more fully the ANPRM and to model additional scenarios, we recommend that the CASB state publicly its willingness to consider additional comments on the ANPRM, provided that those comments are submitted prior to December 3, 2008.

Although we have listed our organizational affiliations and contact information, please note that we are making our response as individuals. As such, this response does not necessarily represent the views of our employers.

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Comments on ANPRM

	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O
1							Contractor A						Contractor B		
2					Year 1		Year 2		Total		Year 1		Year 2		Total
3															
4	***Basic Data***														
5															
6	Minimum required funding (MRF)														
7		Before reduction for prefunding credits			2,000		2,000		4,000		2,000		2,000		4,000
8		Prefunding credits			0		0				0		(2,000)		
9		After reduction for prefunding credits			2,000		2,000		4,000		2,000		0		2,000
10															
11	CAS 412 pension cost				1,700		1,700		3,400		1,700		1,700		3,400
12	Assumed flexibly priced Government contracts				100%		100%				100%		100%		
13	Contributions				2,000		2,000		4,000		4,000		0		4,000
14															
15	***ANPRM Calculations***														
16															
17	Minimum required funding after prefunding credits				2,000		2,000				2,000		0		
18	Less CAS 412 pension cost				(1,700)		(1,700)				(1,700)		(1,700)		
19	New mandatory prepayment credits				300		300				300		0		
20															
21	Starting mandatory prepayment credits				0		300				0		300		
22	New mandatory prepayment credits				300		300				300		0		
23	Less amount applied to fund pension cost				0		0				0		(300)		
24	Less amount otherwise allocated as charge				0		(60)				0		0		
25	Ending mandatory prepayment credits				300		540				300		0		
26															
27	Starting voluntary prepayment credits				0		0				0		2,000		
28	New voluntary prepayment credits				0		0				2,000		0		
29	Less amount applied to fund pension cost				0		0				0		(1,400)		
30	Ending voluntary prepayment credits				0		0				2,000		600		
31															
32	Cost recovery														
33		CAS 412 pension cost			1,700		1,700		3,400		1,700		1,700		3,400
34		Additional mandatory prepayment charge			0		60		60		0		0		0
35		Total			1,700		1,760		3,460		1,700		1,700		3,400
36															
37	***Suggested Calculations***														
38															
39	MRF before reduction for prefunding credits				2,000		2,000				2,000		2,000		
40	Less CAS 412 pension cost				(1,700)		(1,700)				(1,700)		(1,700)		
41	Excess of MRF over CAS cost				300		300				300		300		
42															
43	Starting standard prepayment credits				0		0				0		2,000		
44	Contributions				2,000		2,000				4,000		0		
45	Less CAS 412 pension cost				(1,700)		(1,700)				(1,700)		(1,700)		
46	Less excess of MRF over CAS				(300)		(300)				(300)		(300)		
47	Ending standard prepayment credits				0		0				2,000		0		
48															
49	Starting mandatory prepayment credits				0		300				0		300		
50	Transfer from standard due to excess MRF				300		300				300		300		
51	Less amount applied to fund pension cost				0		0				0		0		
52	Less amount otherwise allocated as charge				0		(60)				0		(60)		
53	Ending mandatory prepayment credits				300		540				300		540		
54															
55	Cost recovery														
56		CAS 412 pension cost			1,700		1,700		3,400		1,700		1,700		3,400
57		Additional mandatory prepayment charge			0		60		60		0		60		60
58		Total			1,700		1,760		3,460		1,700		1,760		3,460