July 16, 2010

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

Re: CAS Pension Harmonization NPRM

This letter provides our response to the Notice of Proposed Rulemaking ("NPRM") issued on May 10, 2010 by the Cost Accounting Standards ("CAS") Board ("Board") pertaining to the harmonization of CAS 412 and 413 with the Pension Protection Act of 2006 ("PPA").

As in our previous comments, we commend the CAS Board for identifying and grappling with issues that are critical to harmonization. In particular, we appreciate the Board's efforts to simplify the rule and to explain its concepts through the use of a comprehensive illustration. That said, although we were optimistic as to acheiving a reasonable degree of harmonization in our November 3, 2008 comments on the ANPRM, we are considerably less optimistic after reviewing the NPRM. This letter explains the reasons for our disappointment.

Congress' Charge to the CAS Board

Before presenting our specific comments, it is useful to first step back to review the task at hand. Section 106 of the PPA instructs the Board to:

> … review and revise [CAS 412 and 413] to harmonize the minimum required contribution under the Employee Retirement Income Security Act of 1974 …

Merriam-Webster's Online Dictionary defines "harmonize" as "to bring into consonance or accord." Our thinking continues to be that the best approach to harmonization would be to revamp CAS 412 and 413 to follow PPA, with modifications as necessary to meet the unique requirements of Government contracts.[1] Other bodies that regulate pension costs and funding – primarily Congress and the Financial Accounting Standards Board ("FASB") – have concluded that the so-called "long term" methodology that was

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[1] See our August 9, 2007 and November 3, 2008 submissions.

universally used when CAS 412 was introduced in the 1970s is no longer appropriate for a variety of reasons.

Notwithstanding this clear direction in the pension industry – where the prior approach was replaced with the new approach – the CAS Board is attempting to craft a rule that layers PPA methodology on top of the historical CAS 412 calculation approach. It was clear to us at the outset that such an approach would be quite complex, which prompted our initial concern. Now that we have modeled results under the NPRM, it is clear that this complexity is also associated with unexpected and undesirable results.

On balance, we believe that the Board's goal – to create a version of CAS that harmonizes with both the minimum funding requirements of PPA and the historical versions of CAS 412 and 413 – is not viable. Based on our analysis, as described in more detail below, it simply is not possible to harmonize CAS 412 with both PPA and the present version of CAS 412. Rather, the CAS Board should simply carry out Congress' instructions and harmonize CAS 412 with the minimum required contribution under PPA. Consistent with the direction taken by Congress and the FASB, we urge the Board to abandon the so-called "long-term" approach to facilitate a more straightforward pension accounting practice under Government contracts.

With that background, the first portion of the letter explains our analysis of the NPRM and offers our recommendations for improvement, based on the assumption that the Board will not reconsider its decision to add PPA-type calculations on top of the current CAS requirements. At the end of the letter we offer our thoughts on a preferable approach to harmonization.

Quantifying Harmonization

The Board stated in the NPRM that one of its objectives is to "harmonize[] the disparity between the PPA minimum contribution requirements and Government contract costing" (see prefatory comment to NPRM at May 10, 2010 Federal Register ("FR") at 25984). The NPRM further states that the rule "should provide relief for the contractors' concerns with indefinite delays in recovery of cash expenditures while mitigating the expected pension cost increases that will impact Government and contractor budgets" (see id.).

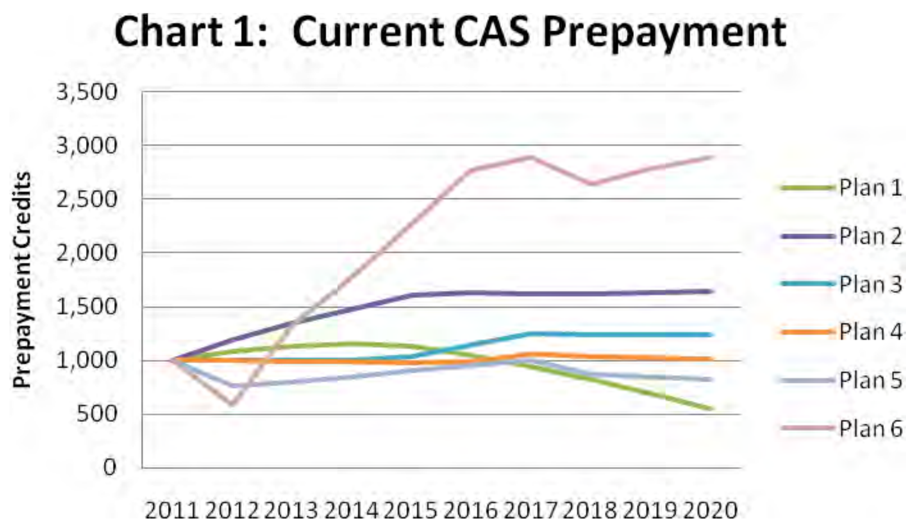
The passage of the PPA, coupled with required deficit reduction contributions prior to PPA and the economic downswing of 2008, forced many contractors to make substantial contributions to their pension plan in recent years. In most situations with which we are familiar, recent contribution requirements have far exceeded CAS 412/413 costs, which in turn has resulted in the creation of substantial unreimbursed contributions, i.e., prepayment credits. The transition rules contained in the NPRM will further exacerbate the situation by creating yet additional prepayments.

As part of our evaluation of the NPRM's impact on CAS costs and our assessment of alternative approaches, data from five major defense contractors (seven distinct

pension plans) were modeled and analyzed under a variety of scenarios as described throughout this letter.[2] These results were then "normalized"[3] to permit the identification of "real world" trends without attribution to individual contractors.

For the sake of simplicity, our analysis utilizes prepayment credits to assess the extent to which harmonization is achieved.[4] For example, the absence of prepayment credits indicates that harmonization has been achieved. On the other hand, prepayment credits that grow or remain level suggest that harmonization is not occurring.

Our base case presumed that no changes would be made to the current version of CAS 412 and 413. As shown in Chart 1 below, in the absence of harmonization, most contractors would expect their prepayment credits to remain steady or grow over the next 10 years:[5]



With that background, we now address those aspects of the NPRM that seem particularly problematic from the perspective of achieving harmonization: (1) the

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2 Some contractors reported combined results for several pension plans while others provided plan-by-plan results.

3 For example, as shown in Chart 1, projected prepayment credits for each of the seven plans were projected from 2011 through 2020 and were then adjusted so that the initial value for each plan was set equal to $1,000.

4 Each contractor utilized a funding policy whereby the amount contributed was set equal to the greater of (1) the PPA minimum contribution or (2) the amount required to fully fund the CAS pension cost. Thus, presumed future funding did not include any discretionary amounts.

5 Under the current CAS, the normalized prepayment credit for Plan 7 would grow to in excess of $12,000 by 2017 and would be approximately $9,800 by 2020. We have excluded Plan 7 from the illustrative charts shown in this letter so as to not distort the results for the other plans.

restrictions imposed by "Trigger 1", (2) the calculation of segment closing liabilities and (3) the apparent confiscatory treatment of prepayment credits.

Trigger 1 Prevents Harmonization

NPRM 412-50(b)(7)[6] requires that a plan's minimum required contribution ("MRC") must exceed the NPRM 412 unadjusted pension cost for the harmonization rule to apply during that accounting period:

> … in any period that the minimum required amount, measured for the plan as a whole, exceeds the pension cost, measured for the plan as a whole [but not less than zero], the actuarial accrued liability and normal cost are subject to adjustment …

We refer to this test as "Trigger 1" throughout this letter. Trigger 1 means that the traditional actuarial accrued liability ("AAL") and normal cost ("NC") would be applied to calculate the CAS cost if the MRC is less than the CAS pension cost. Notwithstanding the facial appeal of this approach – if the CAS cost is greater than the MRC, why would harmonization be needed? – the technical aspects of the proposed rule do not yield the intended result. <u>That is because the proposed rule incorrectly treats the annual MRC/CAS comparison as an independent event while, in fact, these comparisons must be considered in a more comprehensive manner over a period of years</u>.

In crafting this rule, it seems clear that the Board did not anticipate that Trigger 1 would prevent harmonization. To illustrate, the Board observed "that during periods of low corporate bond rates the recognition of the minimum actuarial liability and minimum normal cost will harmonize the CAS with the measurement of the PPA minimum required contribution with only a slight lag in recognition due to differences in amortization periods (7 years vs. 10 years)" (<u>see</u> FR at 25991)[7] The fundamental flaw of Trigger 1 can be illustrated with the following simple example. Consider the following situation:

- A plan with neither CAS prepayment credits nor ERISA prefunding balances at the PPA effective date.
- All actuarial assumptions are assumed to remain constant and there are no actuarial gains or losses.
- The MAL and MNC are projected to exceed the AAL and NC, respectively, for the foreseeable future.

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[6] Throughout this letter, "NPRM 412- …" cites to the proposed NPRM and "CAS 412- …" cites to a section of the present CAS.

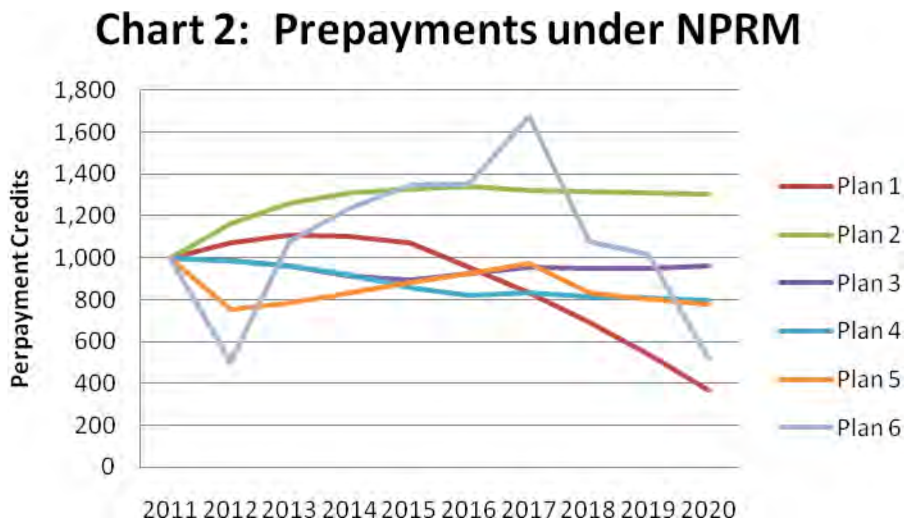
[7] Later, in Topic N, we believe the CASB also incorrectly states that "the allocable contract cost will approximate or exceed the PPA minimum required contribution." As noted in the example above, the allocable contract cost in some years will be less than the required contribution and in other years Trigger 1 eliminates any opportunity to recover that difference.

- PPA and harmonized CAS take effect on the same date.

- The unfunded liability at the PPA effective date is amortized over 7 years for PPA and over 10 years for CAS purposes.

The MRC would exceed the NPRM cost in years 1 through 7 because PPA would amortize the unfunded liability (technically, the PPA "funding shortfall") over 7 years while the CAS cost would include amortization of the unfunded portion of the MAL over 10 years. Over this 7 year period, the excess of the MRC over the CAS cost would build a CAS prepayment credit. In years 8 through 10, however, Trigger 1 generally would not apply because the MRC would decline following the completion of the 7 year PPA amortization schedule while the CAS amortization schedule would still have 3 years remaining. Thus, the failure to satisfy Trigger 1 would effectively preclude the application of NPRM 412-50(b)(7) in years 8 and later, which in turn would prevent full amortization of the MAL unfunded liability at transition.

Chart 2 following illustrates the prepayment credits associated with pension costs computed under the NPRM.[8]



As compared to the current version of CAS in Chart 1, Chart 2 moves more in the direction of achieving harmonization. However, only 2 of the 7 plans are clearly moving towards harmonization after 10 years. Accordingly, Chart 2 demonstrates that the NPRM does not achieve harmonization.

We noted the following additional problems with Trigger 1:

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[8] As with Chart 1, Plan 7 was eliminated to preserve the scale. Prepayments under Plan 7 peaked at about $7,100 in 2017 and ended at $6,600 in 2020.

1. Complexity. Many contractors must estimate future CAS expense for forward-pricing purposes when bidding on multi-year contracts. The NPRM would require contractors to project minimum required contributions for each future year, which is itself a complex exercise. Such complexity will increase the likelihood of errors, would significantly increase the difficulty in auditing these costs and would likely lead to additional disputes between the parties.

2. Disclosure requirements. The explicit linkage between CAS pension costs and the MRC would seem to result in MRC projections being subject to the Truth in Negotiations Act ("TINA"). In many respects, this would only require additional disclosure that would presumably be made in the normal course of business. However, care would need to be taken concerning complex decision points concerning the potential waiver of prefunding balances that plan sponsors may make under PPA.[9] In addition, if this requirement is retained, contractors would be placed in the untenable position of certifying projections of PPA MRCs in the same manner as other cost or pricing data, even thought MRCs are calculated by enrolled actuaries who are typically employed by a third party; as such, the CAS Board should provide that a contractor may rely upon an enrolled actuary's projection of the MRCs.[10]

3. PPA change in cost accounting practice. The parties have long recognized that changes in ERISA methodology do not represent a change in cost accounting practice for CAS purposes. Under the terms of the NPRM, however, that might change. For example, if the PPA asset smoothing method is changed, and that change impacted the MRC, which in turn impacted the CAS cost, auditors might reasonably contend that the impact of that change represents a change in cost accounting practice.

   Our primary concerns here are the gray areas. Because the IRS does not promulgate ERISA regulations with Government contracting in mind, optional approaches under PPA might be provided to plan sponsors from time to time that, in the view of a Government auditor, might arguably be considered to be a cost accounting change. These situations are potentially problematic and offer additional support to our view that CAS should not be explicitly tied to the MRC.

4. Volatility/unpredictability. One of the goals of the NPRM, as stated in the preamble, is to enhance predictability of pension costs. Our analysis shows that the use of

[9] Section 412-50(b)(7)(iii)(C) of the NRPM seems to suggest that current period PPA elections are not counted but does not address prior period elections. Any attempt to remove the impact of past elections – which would be the proper result in our view – would be complex and would require additional CAS coverage. This issue is moot if Trigger 1 is eliminated.

[10] We also note that the original Board required actuarial assumptions to be selected by contractors rather than enrolled actuaries because "it is the contractors who are parties to contracts with the Government and must bear the responsibility for compliance with the terms thereof" (see Prefatory Comment 5 to original version of CAS 412).

Trigger 1 can significantly increase volatility because a relatively small change in either the unadjusted CAS cost or the MRC can "flip the switch" and thus result in substantial swings in pension costs.

The predictability problem is magnified for plans that are close to full funding. Attachment 1 provides a simple illustration of a pension plan where assets are initially equal to liabilities for both CAS and PPA purposes (the difference between the MAL and the AAL equals the NPRM prepayment credit). Thus, in year 1, the CAS cost equals the NC and the MRC equals the MNC; because the MNC exceeds the NC, Trigger 1 applies.

Over the course of year 1, the plan's investments return 7%, which represents a <u>loss</u> versus the 8% CAS assumption and a <u>gain</u> versus the 6% PPA assumption. For CAS purposes, the loss is amortized. Under PPA, however, the gain results in a surplus that is recognized immediately in determining the MRC. Because the immediate recognition of the gain reduces the MRC to a level below the CAS cost, Trigger 1 does not apply in year 2. In turn, this means that the assignable cost limit ("ACL") for year 2 is calculated using CAS assumptions, which in turn limits the cost to zero. Note that if Trigger 1 had been satisfied, however, the ACL would have been equal to $991 (that is, MAL of $6,487 <u>plus</u> MNC of $130 <u>minus</u> assets of $5,626).

In year 2, assets return 5%, which yields a loss for both calculations. Because the MAL/PPA "Funding Target" in year 3 exceeds assets, the MRC is calculated by amortizing the funding shortfall and the MRC once again exceeds the CAS cost and the Trigger 1 criteria are met. Therefore the ACL equals $1,247 (that is, MAL of $7,014 <u>plus</u> MNC of 140 <u>minus</u> assets of $5,907). If Trigger 1 had not been met for year 3, however, the ACL would have been $280 (that is, AAL of $6,067 <u>plus</u> NC of $120 <u>minus</u> assets of $5,907).

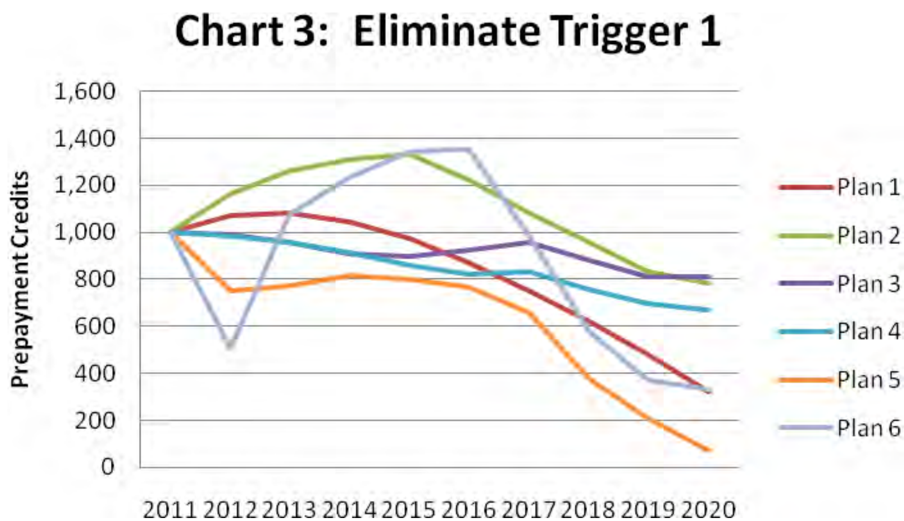
In our view, the "zig zag" pattern of pension costs presented on Attachment 1 will be problematic for both parties. We further note that harmonization does not occur on Attachment 1, as the prepayment credit balance after 3 years is virtually unchanged from the initial balance. In contrast, Attachment 2 illustrates that costs are far less volatile if Trigger 1 is eliminated. In addition, the prepayment credit balance shown on Attachment 2 has dropped after 3 years, thus indicating a move towards harmonization.

Our analysis showed that the volatility and unpredictability associated with Trigger 1 is magnified in other situations, including plans using segment accounting, situations where the PPA interest rates fluctuate and where different asset smoothing techniques are present for PPA vs. CAS.

5. <u>Inconsistency with CASB goals</u>. The CASB stated in the preamble to the NPRM that one of its "Harmonization Goals" was "[n]o direct adoption of ERISA as amended by the PPA, to avoid any change to contract cost accounting without prior CAS Board

approval since Congress will amend ERISA in the future" (see FR at 25984). Because NPRM 412-50(b)(7)(iii)(C) defines the MRC as "the contribution required to satisfy the minimum funding requirements of ERISA," the terms of the NPRM conflict with the CASB's goals.

As explained above, Trigger 1 prevents the harmonization of CAS costs with the minimum funding requirements of PPA. To correct this problem, we propose that Trigger 1 be eliminated. Under our approach, the harmonization rule would be based upon the adjusted AAL and NC if the sum of the minimum actuarial liability ("MAL") and minimum normal cost ("MNC") exceeds the sum of the unadjusted AAL and unadjusted NC. Chart 3 following illustrates the impact of eliminating Trigger 1:



By comparing Charts 2 and 3, it is clear that elimination of Trigger 1 improves harmonization. We also note that the elimination of Trigger 1 has a minimal financial impact in the early years of the analysis and hence would have little impact on the Federal procurement budget over the next 5 years. Notwithstanding, even if Trigger 1 is removed, the prepayment credits that exist at transition, and generally increase through the end of the five year transition period, are not eliminated in a systematic way, as shown on Chart 3 (specifically, only 3 of the 7 plans show a marked reduction in prepayment credits over the 10 year period). We believe that the primary cause of this phenomenon is the expected continued spread between the underlying interest rates between PPA and CAS. Because the whole purpose of harmonization is to recognize these prepayment credits on a timely basis, the CAS Board should seek another approach to recognizing these prepayments. Within the framework of the NPRM, the easiest approach to dealing with this problem would be to amortize the prepayment credits that existed at either the date the harmonization rule first applies or, alternatively,

at the end of the transition period.[11] In our view, a much simpler approach would be to harmonize CAS using the PPA "building blocks" as discussed below.

Segment Closing Calculations

In the absence of a plan termination, the NPRM provides that segment closing calculations (including curtailments) are to be made using the accrued benefit cost method AAL (see NPRM 413-50(c)(12)), which is based upon long-term actuarial assumptions. As explained below, we believe that this result is theoretically unsound and can be unfair to either party depending upon the prevailing interest rates at the time of the closing. Before explaining why, however, some additional background is useful.

The NPRM provides for two measures of assets and two measures of liabilities. The various asset and liability measures have different volatility attributes:

- Relatively stable measures. Because the AAL "shall reflect long-term trends so as to avoid distortions caused by short-term fluctuations" (see CAS 412-50(b)(4)), AALs tend to be relatively stable. Similarly, the actuarial value of assets ("AVA"; see CAS 412-30(a)(15)) typically smoothes fluctuations in the market value and hence is relatively stable. Neither the AAL nor the AVA provide an acceptable snapshot of a plan's funded status at a point in time (i.e., segment closing).

- Relatively volatile measures. The market value of assets ("MVA"; see id.) is, by its very nature, quite volatile. Similarly, the MAL is based upon the "rates at which the pension benefits could effectively be settled based on the current period rates of return on investment grade fixed-income investments" (see NPRM 412-50(b)(7)(iv)(A)) and is likewise volatile. The MVA and the MAL provide the most accurate measure of a plan's funded status at a point in time.

Because the NPRM compares the volatile MVA against the stable AAL, the amount of segment closing adjustment (i.e., the difference between the two amounts) will fluctuate wildly. Such a result makes no sense theoretically and would reward one party, and penalize the other, in an arbitrary manner. It further seems odd that the NPRM could result in a situation where settlement assumptions would be used during the going-concern phase of a segment while going-concern assumptions would be used in the settlement calculation made in connection with a segment closing!

Contrary to the wishes of Congress, we note that NPRM 413 provides relief for contractors who terminate a defined benefit plan (instead of the AAL, liabilities are measured by the cost of annuities which are comparable to the MAL) while penalizing Contractors who continue their defined benefit plans in force.

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[11] Amortization could be limited to the "mandatory prepayment credits" as defined in the ANPRM. However, we do not believe that the added complexity of limiting the calculation to Mandatory Prepayments is justified.

More importantly, the treatment proposed in the NPRM would effectively prevent harmonization. Coincident with directing the harmonization of CAS with PPA, Congress established the "funding target" ("FT") as the optimal level of pension funding. Because the FT and the MAL are, for all practical purposes, identical at segment closing, PPA essentially contemplates that assets equal to the MAL would have been accumulated at segment closing.

By basing the segment closing on the AAL rather than the MAL, however, the NPRM effectively reverses harmonization on a cumulative basis. This means that any increases in CAS pension cost recovery that resulted from harmonization would need to be refunded to the Government at the time of segment closing. In effect, one Government agency would penalize a contractor if its pension assets are below the MAL while another would demand a refund of any excess of the MAL over the AAL. Because the contributions required by PPA (and reimbursed under Government contracts) are maintained within the pension fund, a contractor closing a segment would be required to refund to the Government, from its corporate treasury, the cumulative amount of pension costs that it had recovered under the harmonization rule.

This "deharmonization" rule would create a financial "ticking time bomb" for contractors. Clearly the segment closing rule proposed in the NPRM would not achieve harmonization. In addition, because CAS 413 provides that annuity purchase prices are used to measure liabilities in the event of a plan termination, but not in the case of a segment closing or curtailment, the segment closing provisions of the NPRM may encourage contractors to terminate their pension plans in connection with segment closings or curtailments. We further note that encouraging contractors to exit the defined benefit system as a means of avoiding the potentially devastating segment closing adjustments would, under the current CAS and established case law, create substantial Governmental obligations.

In our view, the CAS Board should calculate segment closing adjustments based on the difference between the MVA and the MAL, where the MAL would be based upon the most recent set of interest rates that are available as of the segment closing date, based upon the Contractor's disclosed practices, thereby ensuring that both assets and liabilities used for segment closing purposes are based on consistent, market-based assessments of economic conditions. The segment closing measure would be less volatile than in the NPRM and the potentially wide-reaching problems resulting from deharmonization at segment closing would be eliminated.

Prepayment Credits

In response to ANPRM comments, the Board indicated that interest adjustments on costs were governed by the Federal Acquisition Regulation ("FAR"). Notwithstanding, several purported "technical corrections" were made in the NPRM which appear to change longstanding aspects of CAS 412 and 413. Specifically, the proposed changes at NPRM 412-60(c)(5), and the addition of NPRM 412-60.1, suggest that prepayment credits must be applied as of the beginning of the year and hence would not be adjusted

for interest to reflect the contractor's historical timing of pension funding. These changes – which have nothing to do with PPA – are patently unfair and would reduce long-term pension cost recovery for many contractors on the order of 5%. If sustained, this approach would accelerate the movement of contractors away from defined benefit pension plans – which would likely increase the amount of pension costs allocated to Government contracts through plan terminations.

As background, contractors typically calculate CAS pension cost based upon planned funding dates. Because pension actuarial valuations are typically performed as of the beginning of a plan year, pension costs are adjusted at the valuation rate from the beginning of year to the anticipated dates of payment. To avoid unallowable interest costs, FAR 31.205-6 requires pension costs to be funded within 30 days after the end of each quarter to which they are assignable (notably, the FAR does not require a contractor to fund the full pension CAS cost as of the beginning of the year). The Defense Department has accepted contractors' calculations of pension cost including interest to the quarterly funding dates since at least 1987.[12]

The reason the Government has accepted contractors' quarterly funding practices is that this approach reasonably aligns required cash funding (i.e., contractors' cash outgo) with recovery of pension costs (i.e., contractors' cash income) which, it must be remembered, is one of the goals of harmonization. Because contractors cannot recover their annual pension costs under their Government contracts on the first day of a year, but rather recover these costs through installments throughout the year, the Board should not attempt to expropriate prepayment credits at the beginning of the year. Further, because the PPA has quarterly cash funding requirement dates of April 15th, July 15th, October 15th, and January 15th, a contractor may not know the exact quarterly minimum funding requirements at the beginning of the year and consequently how much of the CAS pension cost can be funded with cash versus accumulated prepayment credits.

We further note that accumulated prepayments credits belong to the contractor, not the Government. They are the result of amounts funded in excess of the CAS pension cost assigned to a cost accounting period, and typically result from the application of the minimum funding requirements, both before and after the effective date of PPA, which have typically yielded contribution requirements in excess of CAS costs.

At present, CAS 412 does not require a contractor to use prepayment credits to fund the pension CAS cost during a year when CAS cost exceeds minimum funding requirements.[13] In future years, contractors may be more likely to make contributions in

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[12] See item e. at page 34 of the 1987 CIPR manual attached. Note that one payment made 8.5 months into a year is mathematically equivalent to quarterly payments made a month after the end of each quarter of the year, consistent with FAR requirements.

[13] For example, CAS 412-60(d)(4) states that "prepayment credits … may be used to fund the next year's assigned pension cost, if needed." Emphasis added.

excess of minimum funding requirements to avoid the restrictions imposed by PPA when the pension plan's funded status is relatively low.

To illustrate, a pension plan may be deemed "at risk" under PPA if its funded status is less than 80%. In this situation, the contractor is not technically "required" to make the additional cash contributions that would be necessary to avoid PPA's "at risk" designation. Notwithstanding, the contractor may wish to make these additional contributions to avoid unfavorable consequences, such as increased minimum funding requirements and participant notices. Because failure to make the additional contributions may harm employee morale, the Government would benefit from these additional contributions. Furthermore, these additional contributions are exactly what Congress had in mind when it enacted these rules. Accordingly, it would be inappropriate for the Government to discourage contractors from making any such contributions by effectively seizing control of these contributions/CAS prepayments.

As currently drafted, two otherwise identical contractors would recover different amounts of cost solely on account of one using cash funding while the other applied prepayment credits. For example, suppose the CAS assignable cost, measured on the first day of the year, was $100 for both Contractor A and Contractor B; further suppose that Contractor A had accumulated prepayment credits of $1,000 but Contractor B had no prepayment credits. Under the NPRM, Contractor A's recovery would be limited to $100, which would be recovered from the Government throughout the year. On the other hand, Contractor B would be permitted to adjust its $100 cost in recognition of the quarterly funding dates[14] to approximately $105. Thus, Contractor B would contribute $100 CAS cost plus $5 in quarterly payment adjustments in April, July, October and January of the subsequent year, and would recover $105 over the course of the year.

Despite having identical CAS costs, Contractor A would be penalized by realizing $5 less in cost recovery, thereby compounding the negative cash flow it suffered in previous years due to the mismatch between CAS cost recovery and minimum funding requirements. It simply is not equitable to penalize Contractor A for being forced to make contributions in excess of its assignable pension CAS cost.

The provision of the NPRM that results in the $100 CAS cost for Contractor A versus the $105 for Contractor B is the equivalent to the CAS Board forcing Contractor A to provide an interest free loan to the Government for a half a year or so. As noted above, the contractor will not recover the $100 from the Government at the beginning of year, but throughout the year. This aspect of the NPRM is not a technical correction but rather a substantive change unrelated to PPA.

The inequitable treatment of interest on prepayment credits should not be a factor that influences the contractor's decision to use prepayment credits or fund in cash which, according to the original Board, was intended to be an investment decision. The proper

[14] The 5% adjustment is consistent with the 8.5/12 formula contained in the Government's 1987 guidance discussed above.

result would provide equitable treatment by allowing Contractor A to recover the same $105 in pension CAS cost as for Contractor B. This would allow these contractors to be treated consistently, and would not discourage contractors from advance funding – a practice which Congress plainly intended.

We believe the Board's illustrations regarding the application of the accumulated value of prepayment credits as of the beginning of the year are not related to PPA and hence should be eliminated. Alternatively, the CAS Board should clarify that contractors may apply prepayments at their planned funding dates, consistent with current practice. Because the Board has not discussed the implications of this potentially significant change – a 5% decline in pension cost recovery for the foreseeable future for most large contractors – we believe that this change has not complied with the statutory promulgation process.

Miscellaneous

In addition to the preceding major issues, we also offer the following comments:

1. Equitable adjustments. When CAS 412 is amended to harmonize with PPA, contractors will be entitled to an equitable adjustment. While the Board has indicated that the calculation of equitable adjustments is beyond their authority, it did indicate that the NPRM would represent a single change in accounting practice. Due to the complexity of pension accounting, we suggest adding an illustration clearing stating the calculation of the impact of the change in cost accounting practice, which would thereby minimize administrative costs as well as the potential for disputes between the parties.

2. Actuarial asset value. Although PPA requires the CAS Board to harmonize CAS with the PPA minimum contribution, the NPRM continues to ignore that the PPA minimum amount is a function of assets as well as liabilities. We do not understand why the Board is resistant to aligning the asset values for PPA and CAS, as we believe that mandating contractors to use the same asset smoothing methodology for CAS as is used for PPA will enhance harmonization (due to eliminating a difference between CAS and PPA), will reduce complexity and will minimize audit issues, contract disputes and administrative costs.

   Having said that, we do understand that the 10% PPA corridor may yield more volatile/less predictable results. To address this, we recommend that contractors be permitted to adopt their PPA asset smoothing methodology as a deemed desirable change in connection with the transition to harmonized CAS, but with a 20% corridor.

3. Fees charged against prepayments. NPRM 412-30(a)(23) provides that prepayment credits are to be "adjusted for investment returns and administrative expenses." Because investment management costs are incurred on all plan assets, including prepaid contributions, we agree that investment-related fees should be applied to

offset returns for purposes of tracking prepayment credits. On the other hand, benefit administration fees (participant recordkeeping, pension payroll, etc.) are not impacted by prepayments and should instead be borne by the segments that participate in the plan and hence give rise to those costs. We suggest that the language at NPRM 412-30(a)(23) be modified to read "adjusted for investment returns and investment-related administrative expenses."

4. Investment return on prepayments. To avoid potential confusion, we recommend that NPRM 412-30(a)(23) explicitly provide that the average rate of investment return for a year can be used to adjust all cash flows occurring in that year. This would eliminate the possibility that an auditor might require a contractor to measure investment returns within a plan year, which would be a difficult and expensive task.

5. Assignable cost limit. As demonstrated above, switching back and forth between the AAL/NC and the MAL/MNC increases volatility. Accordingly, we disagree with the Board's conclusion that the NPRM "provides sufficient smoothing of costs to reduce volatility" which is why "the NPRM does not include any assignable cost limitation buffer" (see FR at 25984). Accordingly, we urge the CAS Board to reconsider its position concerning including a buffer in the ACL conceptually similar to that suggested in the ANPRM.[15]

6. Post-segment closing calculations. We agree conceptually with the addition of NPRM 413-50(c)(12)(ix). However, CAS 412-30(a)(22) defines "permitted unfunded accruals" in the context of a nonqualified plan. In our view, a simpler approach would be to merely require the segment closing adjustment amount to be treated as a prepayment credit (if a surplus) or as an amount to be identified pursuant to CAS 412-50(a)(2) (if a deficit). We further note that prepayment credits, to the extent they are maintained at the plan level (which is generally the case, but not always), need not be transferred to a home office following the segment closing. In addition, to avoid confusion, we suggest that the language clarify that it is the gross credit/charge (i.e., not limited to the Government's share) that is to be recognized.

7. Exceptional events. The Board stated that it "was interested in any comments concerning whether the gain or loss from exceptional events should be amortized over a longer period…also… on how such exceptional event might be defined or identified" (see FR at 26001). This is really the same problem that the Board debated in the early 1990s concerning the sudden and unexpected entry to/emergence from full funding, and the consequent impact on firm fixed-price contracts. We believe that any such change should be debated separately from this harmonization project and, in particular, should not emerge at this late stage in the promulgation process.

[15] Page 8 of our November 3, 2008 submission included comments on how the ACL buffer might most effectively operate in practice. While we suggested using 125% of the AAL in our previous response, we believe that using even 110% of the AAL would provide significant reduction in volatility.

Alternative Approach

To be clear, the complexity resulting from the mixing of "long-term" and current point-in-time liability measurements is not in the calculations themselves, but rather in the unintended results that will emerge from such complicated rules. Although our analysis has uncovered a number of technical issues, others have likely escaped detection. In contrast, a revised CAS 412 modeled after PPA would be more straightforward and hence less likely to yield surprises.

At the beginning of this letter, we expressed our view that a better approach to harmonization would be to scrap the so-called "long-term" approach that has been contained in CAS 412 since the 1970s and instead "tag along" with the "mark to market" direction taken by Congress in PPA. Key principles of such a rule would encompass the following concepts:

- Building blocks. Pension costs would be based upon the "building blocks" comparable to those defined in PPA. CAS liabilities would track the PPA funding target and the CAS normal cost would track the PPA funding target normal cost. CAS assets would equal the PPA asset value with appropriate adjustments for CAS prepayment credits.

- Amortization. Amortization payments would generally follow the PPA approach but, to enhance predictability and reduce volatility, a 10 year amortization period would apply for all amounts (i.e., the process would parallel that for the 7 year amortization used under PPA).

- Transition to harmonized rule. The amounts of pension cost allocated to Government contracts in recent years have often lagged well behind the amounts of pension contributions. Since "what goes around comes around," these additional pension costs will be recognized in Government contracts at some point in time. All parties are rightfully concerned with the significant amount of these costs. Consistent with the concepts contained in the NPRM, we suggest that the differences between the liabilities and normal costs between the present and harmonized rules be transitioned over a 5 year period.

Although we cannot speak for the defense industry, we believe that a more straightforward approach to harmonization would be preferable to the complexity and volatility embodied in the NPRM. In contrast, in addition to the equitable adjustment issues that are sure to arise under the NPRM, finalizing the regulation in its present form subjects the Government to the risk of significant curtailment/plan termination costs in the coming years.

* * *

We appreciate the opportunity to comment on the NPRM. 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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Attachment 1 to DAG Comments on NPRM

	A	B	C	D	E	F	G	H	I	J
1										
2	Year	1	2	3	4					
3	return	7.0%	5.0%	10.0%	10.0%		Note loss in year 2			
4										
5	**CAS**	8.0%	8.0%	8.0%	8.0%					
6	AAL	5,000	5,508	6,067	6,682					
7	NC	100	110	120	130					
8	Assets	5,000	5,626	5,907	6,820		Equal ERISA assets minus PPCs			
9	UAL	0	(118)	160	(138)					
10	Amort	0	(16)	22	(19)					
11	Cost pre ACL	100	94	142	111					
12	Cost not less than zero	100	94	142	111		Limited per 412-50(c)(2)(i)			
13										
14	**MRC**	6.0%	6.0%	6.0%	6.0%					
15										
16	FT/MAL	6,000	6,487	7,014	7,583					
17	TNC/MNC	120	130	140	150					
18	Assets	6,000	6,548	6,948	7,806					
19	Shortfall	0	(61)	66	(223)					
20	Amort	0	0	8	0					
21	MRC	120	69	148	0					
22										
23	**Harmonized Cost per NPRM**									
24	Trigger 1	TRUE	FALSE	TRUE	FALSE		Trigger 1: True if MRC greater than CAS cost limited by (c)(2)(i)			
25	Trigger 2	TRUE	TRUE	TRUE	TRUE		Trigger 2: True if (MAL+MNC)>(AAL+NC)			
26	HAL	6,000	5,508	7,014	6,682					
27	HNC	120	110	140	130					
28	Assets	5,000	5,626	5,907	6,820					
29	UAL	1,000	(118)	1,107	(138)					
30	Amort	138	(16)	153	(19)					
31	Cost pre ACL	258	94	293	111					
32	Cost not less than zero	258	94	293	111		Limited per 412-50(c)(2)(i)			
33										
34	Trigger 3	TRUE	FALSE	TRUE	FALSE		Trigger 3: True if harmonized cost exceeds standard cost			
35	ACL	1,120	0	1,247	0					
36	**Cost post ACL**	**258**	**0**	**293**	**0**					
37										
38	PPC BOY	1,000	922	1,041	986					
39	MRC funding	120	69	148	0					
40	CAS cost	(258)	0	(293)	0					
41	Interest	60	50	90	99					
42	PPC EOY	922	1,041	986	1,085					

Attachment 2 to DAG Comments on NPRM

	A	B	C	D	E	F	G	H	I	J
1										
2	Year	1	2	3	4					
3	return	7.0%	5.0%	10.0%	10.0%		Note loss in year 2			
4										
5	**CAS**	8.0%	8.0%	8.0%	8.0%					
6	AAL	5,000	5,508	6,067	6,682					
7	NC	100	110	120	130					
8	Assets	5,000	5,626	6,169	7,068		Equal ERISA assets minus PPCs			
9	UAL	0	(118)	(101)	(385)					
10	Amort	0	(16)	(14)	(53)					
11	Cost pre ACL	100	94	106	77					
12	Cost not less than zero	100	94	106	77		Limited per 412-50(c)(2)(i)			
13										
14	**MRC**	6.0%	6.0%	6.0%	6.0%					
15										
16	FT/MAL	6,000	6,487	7,014	7,583					
17	TNC/MNC	120	130	140	150					
18	Assets	6,000	6,548	6,948	7,806					
19	Shortfall	0	(61)	66	(223)					
20	Amort	0	0	8	0					
21	MRC	120	69	148	0					
22										
23	**Harmonized Cost per NPRM**									
24	Trigger 1	TRUE	TRUE	TRUE	TRUE		Set equal to True in all situations			
25	Trigger 2	TRUE	TRUE	TRUE	TRUE		Trigger 2: True if (MAL+MNC)>(AAL+NC)			
26	HAL	6,000	6,487	7,014	7,583					
27	HNC	120	130	140	150					
28	Assets	5,000	5,626	6,169	7,068					
29	UAL	1,000	861	846	516					
30	Amort	138	119	117	71					
31	Cost pre ACL	258	249	257	221					
32	Cost not less than zero	258	249	257	221		Limited per 412-50(c)(2)(i)			
33										
34	Trigger 3	TRUE	TRUE	TRUE	TRUE		Trigger 3: True if harmonized cost exceeds standard cost			
35	ACL	1,120	991	986	666					
36	**Cost post ACL**	**258**	**249**	**257**	**221**					
37										
38	PPC BOY	1,000	922	779	738					
39	MRC funding	120	69	148	0					
40	CAS cost	(258)	(249)	(257)	(221)					
41	Interest	60	37	67	52					
42	PPC EOY	922	779	738	569					

02 Defense Actuaries Group
(07-08-10 12:02)

DLAM 8105.3

DEPARTMENT OF DEFENSE

DEFENSE LOGISTICS AGENCY

DEFENSE CONTRACT ADMINISTRATION SERVICES MANUAL FOR CONDUCTING CONTRACTOR INSURANCE/PENSION REVIEWS

Cameron Station,
Alexandria, Virginia 22304-6100

JUNE 1987

02 Defense Actuaries Group
(07-08-10 12:02)

d. Did the contractor prefund any pension amounts in prior years, the costs of which are allocable to the periods covered by this review?

e. Is the contractor funding pension costs allocable to Government contracts within 30 days following the quarter in which the costs are assignable?

f. Does the amount of cost allocable to Government contracts include interest in excess of a ratio of 8.5 months to 12 months of the annual actuarial interest rate, applied to the contribution due as of the beginning of the valuation period?

g. Does the contractor defer payment of the commercial portion of pension costs beyond the end of a plan year? If so, is interest then allocated to Government contracts in subsequent years as an actuarial loss?

h. Does the contractor have any unallowable pension costs from prior year(s)? If so, are the costs separately identified and eliminated from the unfunded actuarial liability being currently amortized and allocated to Government contracts? Does the contractor have and follow an established and consistent policy for selecting specified amortization periods for unfunded actuarial liabilities? What is the policy? Have there been any recent changes?

i. Actuarial Assumptions:

(1) Does each actuarial assumption used to measure pension cost represent the contractor's best estimate of anticipated experience under the plan?

(2) Has the contractor made any recent actuarial assumption changes?

(3) Are actuarial gains and losses separately identified?

(4) Has an evaluation of the validity of the actuarial assumptions and an analysis of the actuarial gains and losses demonstrated that the assumptions are reasonable in the aggregate?

j. Composite Costs - If the contractor computes composite pension cost covering plan participants in two or more segments, is the base used for allocating such costs representative of the factors on which the pension benefits are based? What is the basis?

k. Segmentation - Determine if any of the following conditions are applicable to the contractor's pension plan(s):

(1) Is there a material termination gain or loss attributable to a segment?

(2) Is the level of benefits, eligibility for benefits, or age distribution materially different for a segment than for the average of all segments?