DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAC 730.8.A.05/2007-03 September 4, 2007

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

SUBJECT: CAS-2007-02S

Dear Ms. Auletta:

We are providing our comments on the Staff Discussion Paper (SDP) – Harmonization of Cost Accounting Standards (CAS) 412 and 413 with the Pension Protection Act of 2006 (PPA), published in the July 3, 2007 Federal Register. The SDP requests public comments on what revisions to CAS 412/413, if any, are required to ensure harmonization with the PPA.

As elaborated below, we do not believe that the pension cost measurement, assignment, and allocation rules in CAS 412/413 merit revision in the name of harmonization with funding requirements of the PPA. In our view, harmony on the funding differences already exists in the form of pre-payment credits. We believe that adopting the PPA funding rules will compromise the CAS statutory objectives of uniform and consistent accounting linking costs with cost objectives on the basis of causal or beneficial relationships.

1. As the SDP stated, basic conceptual differences exist between the PPA and CAS. CAS is based on the going-concern basis; that is, it assumes the company and its pension plan will continue in operation. PPA, on the other hand, uses a settlement approach to value pension plan assets and liabilities. While the purpose of the PPA is to protect employees' benefit security as well as to assure the solvency of the Pension Benefit Guaranty Corporation (PBGC), the purpose of CAS is to assure the proper measurement and assignment of cost based on the beneficial or causal relationship between costs and cost objectives.

2. The PPA establishes a minimum funding requirement and imposes a funding limit for tax purposes, but, as noted by the SDP, it does not establish accounting practices for pension costs. CAS, on the other hand, establishes accounting practices for pension costs for Government contracts and establishes criteria for assigning cost to the appropriate period. The CAS statute, P.L. 100-679 as codified at 41USC 422(f), grants the CAS Board exclusive authority to promulgate cost accounting rules governing measurement, assignment and allocation of costs to Government contracts. For the CAS Board to adopt the PPA funding requirement, which does not prescribe accounting practices, into the CAS would mean that the Board would abdicate its responsibility and authority provided under the statute. We believe that the CAS Board should continue to promulgate accounting rules to achieve uniformity and consistency in cost measurement, assignment and allocation, and to link costs with Government contracts on an objective causal or beneficial relationship basis.

The CAS 413 Preambles[1] discuss the primary goal of cost accounting in assigning cost to the benefiting period as well as fundamental differences between cost accounting and tax policy:

> "The purpose of the Board in promulgating its Standards on pension cost is to establish the criteria for measuring the proper amount of pension cost to be assigned to cost accounting periods for subsequent allocation to negotiated Government contracts. ERISA establishes, among other things, minimum funding Standards for pension plans and provisions affecting deductibility of pension cost for tax purposes. Although there is some commonality between the funding provisions of ERISA and the Standard being promulgated today, **ERISA does not provide for the measurement of pension costs for assignment among cost accounting periods or for the subsequent allocation of such costs to contracts**." (Emphasis added).

3. Adoption of PPA to contract costing would introduce an unpredictable volatility to pension costs from year to year. Because the Department of Defense awards a significant number of firm-fixed price contracts based on estimated costs, the unpredictable volatility would make it extremely difficult to agree on reasonable prices at contractor locations where pension cost is a significant element of the proposed costs. This added difficulty and uncertainty associated with pension cost estimates will result in a prolonged contract negotiation causing a delay in contract award.

4. Congress did not undertake a review of CAS 412/413 and did not mandate that the CAS rules must be revised because of the PPA. Nor did Congress provide a definition for "harmonization." Harmonization occurs when the PPA's purpose and the CAS statute's purposes are both accomplished. Therefore, we consider harmonization to have been achieved to the extent that current CAS 412/413 does not undermine the purpose of the PPA, which is to protect employees' benefit security as well as to assure the solvency of the PBGC.

5. We believe that CAS 412/413 is compatible with the goals of the PPA. We are not aware of any CAS 412/413 provisions that are in conflict with the PPA funding requirement. We believe that CAS is already in harmony with the PPA in that CAS provides for the appropriate accounting treatment of any annual funding differences between the CAS measured amount and the PPA funding requirement as well as for the pension benefit settlement when such events occur.

Our responses to some of the specific questions in the SDP are as follows:

[1] Preamble to Original Publication, 6-2-76

PAC 730.8.A.05/2007-03 September 4, 2007
SUBJECT: CAS-2007-02S

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?

We believe any revisions made to CAS 412/413 should apply uniformly to all cost-based contracts subject to full CAS coverage.

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?

Yes. We believe that Government contractors who have substantial CAS-covered contracts and are subject to the CAS and FAR pension funding requirements rarely, if ever, contribute to PBGC claims nor do they represent the high-profile bankruptcies that trigger PBGC claims. We do not expect that these Government contractors will experience the financial distress that may lead to bankruptcy.

According to the PBGC, the top ten firms presenting claims during the period 1975-2000[2] included four airlines; four steel companies; one insurance firm; and one aluminum company. We did not identify "PPA-eligible" contractors on this list or recognize Government contractors with significant, if any, CAS-covered contracts.

According to Global Insight economic forecasters, U.S. corporate bankruptcies in 2007 are projected to *"occur in the metals, mining and energy sectors, as well as in real estate and closely related industries, such as mortgage banking and residential construction."*[3] Again, we do not find that these predictions relate to "PPA-eligible" contractors or other Government contractors with CAS-covered contracts. Likewise, our review of the largest public company bankruptcies for the years 2004-2007[4] did not indicate the inclusion of contractors with CAS-covered contracts.

With regard to financial strength, it appears that earnings for defense firms have risen steadily in recent years because of sizeable spending increases on defense programs and equipment.[5] The defense industry also appears to be proactively positioning itself for other markets and, thereby, safeguarding its financial health. According to the Center for Strategic and International Studies, expected increasing revenue for the defense industry over the next few years will allow *"strategic breathing room to develop coping strategies for a flat-to-down environment."*

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[2] www.pbgc.gov/docs/2005databook.pdf Table S-5 page 32

[3] http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/12-04-2006/0004484690&EDATE=

[4] www.bankruptcydata.com/research/Ch11_2007.htm

[5] http://www.cbsnews.com/stories/2007/01/25/ap/business/mainD8MSFFR00.shtml

In addition to the lack of Government contractors contributing to PBGC claims in the past and in the future expectation, we believe that the Government contractors' defined benefit pension plans are adequately funded. Further, while CAS measures and assigns pension costs on an on-going concern basis, it provides for a pension cost adjustment on a termination basis when the plan obligation is being settled. Accordingly, 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.

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

As noted above, we believe current CAS 412/413 is already in harmony with the PPA funding requirements.

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 contact 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 Board should retain the current "going concern" basis for the measurement and assignment of the contract cost for the period. The "going-concern" approach reflects the financial, long-term reality associated with pension plans. In order to verify the "going-concern" nature of defined benefit pension plans, we confirmed, with use of the Internet application "FreeErisa"[6] that the majority of defined benefit pension plans of the "eligible Government contractors" date back to the 1940s and 1950s. In the attachment to this letter, we have summarized the long-term existence of these contractor plans.

Contract costs should represent actual cost that the contractor is reasonably expected to incur. Settlement basis does not reflect the likely situation. If in rare instances where a plan termination occurs, CAS 413.50(c)(12) provides for the true-up of any underfunded amount calculated based on the PPA settlement basis.

Question 4(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 plans, 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?

[6] www.freeerisa.com

We believe the Board should continue to utilize the CAS requirements that incorporate the contractor's, long-term, best estimate for all assumptions. Pension plan accounting must necessarily be on a long-term basis since the duration of time from employee accruals of benefits, up until final payout of the benefits earned, extends over a long period. Long-term estimates, considering factors such as historical experience, the contractor's investment strategy and long-range economic forecasts, represent the best estimate of actual pension costs.

The ultimate goal of pension cost accounting is to match assets (that eventually will pay retirement benefits) with the pension obligation. The long-term nature of a defined benefit pension plan, coupled with sound cost accounting practices, dictates continued use of the long-term assumptions, including use of the expected rate of return on plan assets to measure the pension obligation and the pension cost to be assigned to each accounting period. The May 1992 Cost Accounting Standards Board (CASB) Statement of Objectives, Policies, and Concepts described the goals of sound cost accounting and acknowledged that these objectives may differ from financial accounting or tax policy (Emphasis added):

> "The basic premise of good cost accounting is that the measurement, assignment, and allocation of costs to cost **objectives be based on the beneficial or causal relationship between those costs and the cost objectives**."
>
> "As an ideal, each item should be assigned to the cost objective that **was intended to benefit** from the resource represented by the cost, or, alternatively, that caused incurrence of the cost."
>
> "The Board will give careful consideration to the pronouncements affecting financial and tax reporting and, in the development of Cost Accounting Standards, it will take those pronouncements into account **to the extent it can do so in accomplishing its objectives**."

The CAS Board has taken a global and long-term view of pension costs for the simple reason that it is trying to best link those costs with productive work on Government contracts. It thus requires use of long-term best estimates of anticipated experiences. We believe that current requirements for use of the contractor's long term best estimates of anticipated experiences will best achieve matching costs (or resources purchased at cost) with the performance of work on Government contracts. The Government does not receive a varying measure of value of the pension component of an employee's efforts simply because the amount required to be funded under PPA may vary from year to year.

Questions 4(c)(d)and (e): Specific Assumptions regarding (i) Interest Rate; (ii) Salary Increases; (iii) Mortality/(d) Period Assignment (Amortization) and Asset Valuation

As we stated above, we do not support use of any actuarial assumptions that are not based on the contractor's long-term best estimates of anticipated experience, as currently required by CAS 412/413.

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

We do not believe that most Government contractors' defined benefit pension plans are at risk on a going-concern basis. To evaluate the extent of any underfunding of "PPA-eligible" contractor plans, we compared the actuarial value of assets with the actuarial liability reported for tax purposes (FreeErisa) of the plans previously discussed in our response to Question 4a and listed in the Enclosure. We found that only three of the plans indicated an actuarial liability in excess of assets and that the difference ("underfunding") was relatively minor (1-2%) when compared to the liability:

Contractor	Plan Name	AVA less AAL	Percent of AAL
Lockheed Martin	LM Corp Retirement Income Plan	$ (79,261,313)	1 %
Lockheed Martin	LM Retirement Plan for Certain Hourly Employees	$ (15,412,046)	1 %
Raytheon	Raytheon Non-bargaining Retirement Plan	$ (69,475,071)	2 %

Therefore, we believe that the current CAS 412/413 requirement for contractors to fund assignable pension cost in order for such cost to be allowable, has adequately provided for sufficient funding of defined-benefit pension plans. We conclude that maintaining current CAS 412/413 will not undermine the PPA goal to improve the funded status of defined benefit plans and protect the solvency of the PBGC.

However, if it is evidenced that Government contractors' plans are significantly underfunded on a going-concern basis, then the CASB may wish to consider an additional provision incorporated in CAS 412/413 that would provide an accelerated amortization of the significant unfunded actuarial liability, e.g., underfunding in excess of 20% of the actuarial liability.

Question 6: Cash Flow Considerations

We believe that CAS 412 already accommodates situations wherein ERISA funding requirements for an accounting period exceed the measured amount of pension costs under CAS 412. Specifically, CAS 412.50(a)(4) provides that any funding accomplished per ERISA that exceeds the amount required by CAS 412 be treated as a prepayment credit that can be applied to the future-period funding of pension costs. Any "negative cash flow," i.e., PPA required funding in excess of CAS measured pension cost should be considered an investment, similar to a savings account, that will earn guaranteed earnings at the assumed rate of return, even if the investment actually incurs a loss. Any such "negative cash flow" will be mitigated to the extent the contractor will be able to reduce its income tax liability resulting from increased deductions for PPA funding.

This "negative cash flow" is similar to acquisition of capital assets, e.g., buildings, land, equipment, etc., for which the contractor must finance the acquisition but, in accordance with CAS 409, measures for contract costing purposes only a portion of the asset resource consumed in each accounting period as depreciation cost. The wide variance between immediate cash outlay for the acquired asset and the amortized cash recovery over time is mitigated by recognition of CAS 414 "cost of money" for the undepreciated value of the asset. CAS 414 "cost of money," which is an imputed interest on the not-yet-recovered cash outlay, is equivalent to the earnings on prepayment credits at the assumed rate of return provided in CAS 412.

The CAS 413 Preambles described the treatment of prepayment credits available to the contractor:

> "The Board has previously emphasized that the amount of pension cost assignable to a cost accounting period is not necessarily the same as the amount funded for that period. If the amount required to be funded exceeds the amount calculated, the excess amount funded is subject to the provisions of 4 CFR Part 412 (412.50(c)(1)) which states that **"Amounts funded in excess of the pension cost computed for a cost accounting period pursuant to the provisions of this Standard shall be applied to pension costs of future cost accounting periods."** (Emphasis added)

Question 7: Volatility in Contract Cost Projections

We agree that adoption of PPA to contract costing would introduce an unpredictable volatility to pension costs from year to year. Because the Department of Defense awards a significant number of firm-fixed price contracts based on estimated costs, the unpredictable volatility would make it extremely difficult to agree on reasonable prices at contractor locations where pension cost is a significant element of the proposed costs. This added difficulty and uncertainty associated with pension cost estimates will result in a prolonged contract negotiation causing a delay in contract award.

Question 8: Segment Closing

Current CAS 413.50(c)(12) adequately addresses the adjustment to previously determined pension costs in the event of a segment closure, a plan curtailment, or a plan termination. As we commented in response to Question 5, we have not found that Government contractors' defined benefit pension plans are significantly underfunded on a going-concern basis.

For a plan curtailment or a segment closure, CAS 413 provides for an adjustment calculated on a going-concern basis, not on a settlement basis. We believe this is appropriate unless the contractor actually goes out of business, thereby terminating its pension plan. The pension cost adjustment for a plan curtailment or a segment closure on a going-concern basis is appropriate because the contractor continues its business and its pension plan, thereby reflecting true circumstances under which pension costs will continue. If the contractor's plan is terminated, then the current CAS 413 provides for a pension cost adjustment on a settlement basis.

PAC 730.8.A.05/2007-03 September 4, 2007
SUBJECT: CAS-2007-02S

We appreciate your consideration of our comments. Please direct any questions regarding this memorandum to Ms. Fran Cornett, Chief, Accounting and Cost Principles Division (PAC) at (703) 767-3250.

/Signed/
Kenneth J. Saccoccia
Assistant Director
Policy and Plans

Enclosure:
"PPA-Eligible" Contractor Pension Plans

“PPA-ELIGIBLE” CONTRACTOR PENSION PLANS				
Contractor	**Plan Name**	**Actuarial Accrued Liability**	**Valuation Date**	**Effective Plan Date**
Lockheed Martin	LM Corp Retirement Plan for Certain Salaried Employees	$ 7,265,990,154	1/1/2005	***12/31/1942***
Lockheed Martin	LM Corp Retirement Income Plan	$ 6,195,398,443	1/1/2005	***7/1/1943***
Lockheed Martin	LM Retirement Income Plan III	$ 3,556,801,187	1/1/2005	***1/1/1963***
Lockheed Martin	LM Retirement Plan for Certain Hourly Employees	$ 2,430,662,988	12/25/2004	***12/31/1942***
The Boeing Company	Boeing Company Employee Retirement Plan (BCERP)	$ 9,812,152,557	1/1/2005	***1/1/1955***
The Boeing Company	Boeing North American Retirement Plan (BNA)	$ 4,643,928,537	1/1/2005	***10/1/1945***
The Boeing Company	The Boeing Company Pension Value Plan	$ 5,216,488,541	1/1/2002	***1/1/1999***
The Boeing Company	Employee Retirement Income Plan of MDC – Salaried	$ 2,591,318,917	1/1/2005	***12/1/1942***
Northrop Grumman	Northrop Grumman Pension Plan	$ 9,631,595,027	1/1/2005	***1/1/2000***
Northrop Grumman	TRW Salaried	$ 2,701,176,740	1/1/2001	***12/1/1953***
Northrop Grumman	Northrop Grumman Retirement Plan B	$ 1,597,757,830	1/1/2005	***10/1/1978***
General Dynamics	General Dynamics Corp Retirement Plan Government	$ 594,930,341	1/1/2003	***10/1/1956***
General Dynamics	General Dynamics Corp Retirement Plan Commercial	$ 634,463,425	1/1/2005	***10/1/1956***
Raytheon	Raytheon Company Pension Plan for Salaried Employees	$ 4,498,600,949	1/1/2005	***1/1/1950***
Raytheon	Raytheon Non-bargaining Retirement Plan	$ 3,950,464,266	1/1/2005	***12/17/1997***

Source: “FreeErisa.com”

ENCLOSURE