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Cost Accounting Standards Board
Attn: Raymond J.M. Wong
Office of Federal Procurement Policy
725 17th Street, N.W., Room 9013
Washington, DC 20503

July 9, 2010

Re: CAS Pension Harmonization NPRM

Dear Mr. Wong:

We would like to thank the Cost Accounting Standards Board and its staff for the opportunity to comment on the issues related to harmonization of the Pension Protection Act (PPA) and Cost Accounting Standards (CAS) 412 and 413 pursuant to the recently issued Notice of Proposed Rulemaking (NPRM). The comments expressed in this letter represent the views of the undersigned consultants who work frequently with clients who are subject to PPA and CAS 412 and 413. Our views are not necessarily the same as those of our clients or our firm.

Following is a summary of those issues that we feel would warrant further review and consideration before the final rule is published. Given the complexity of these issues, we hope the CAS Board will consider issuing another NPRM prior to the issuance of a final rule.

CAS 412 Harmonization Rule

While we understand the desire to include a comparison between the CAS expense and the PPA minimum required contribution (the Harmonization Threshold Test) as a requirement for using harmonized liabilities, the significant differences between the CAS and PPA methodologies can lead to undesirable outcomes. Based on our modeling, the application of the Harmonization Threshold Test leads to unintended consequences, and in practice does not accomplish the purpose for which we believe it is intended.

In particular, our modeling shows that this comparison does not achieve the desired result because of the numerous technical differences between the calculations of the PPA contribution and the CAS expense. For example, following a period of high PPA minimum required contributions, a plan may fail the Harmonization Threshold Test due to the more rapid funding required under PPA. This may result in a CAS expense that is higher than the PPA cost, because on a CAS basis the full amount of the plan’s funding is yet to be recognized. This difference in the recognition of contributions will cause the plan to fail the Harmonization Threshold Test, but in reality, there is a significant prepayment credit

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existing because of past funding requirements for contributions which exceed the CAS expense. In addition, since the amortization periods under PPA are shorter (7 years vs. 10 or more years under CAS), a plan will fail the Harmonization Threshold Test before the full amount of minimum contributions are reimbursed under CAS 412. We have attached a hypothetical example that illustrates this result for your reference.

Aside from the lower reimbursements that will follow, the residual effect by not passing the Harmonization Threshold Test is that there is a “reversion” of sorts, whereby CAS expense is developed on the long-term, less conservative CAS assumptions. This may ultimately result in a payback of the harmonized amount through reduced CAS expense in later years.

A third issue with the Harmonization Threshold Test is that the test is performed on a plan level basis, whereas CAS expense is developed on a segment basis and then aggregated for purposes of the test. Aside from potential differences among multiple segments in a single plan, there are many plans that also have commercial operations for which CAS 412 does not apply. This means that contractors who have such combined plans may be at an unfair advantage when compared with those who do not have both commercial and contracting segments within one plan, as their CAS expense only applies to a portion of the plan, while the PPA minimum required contribution applies to the entire plan.

In light of these issues, it is our recommendation that the Harmonization Threshold Test be removed from the CAS rules.

Prepayment Credits

We have several comments concerning proposed section 412-50(a)(4) which states that accumulated prepayment credits are to be adjusted for investment returns and administrative expenses. It seems reasonable to us that a proportional share of investment returns and investment related expenses should be allocated to the prepayment credit account, as a prepayment credit represents plan assets. As such, we agree that the prepayment credit should be allocated a proportional share of investment related administrative expenses. On the other hand, it does not seem reasonable that the prepayment credit should received an allocation of any non-investment related administrative expenses (e.g., for items such as plan administration, actuarial fees, and ERISA audits) – these types of expenses are not typically based on asset size, and the existence of a prepayment credit will not generally affect these fees.

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In addition, we find the example in proposed section 412-60(b)(1) to be a somewhat confusing illustration of how prepayment credits are used and how interest is credited. In particular, the approach shown appears to require the application of the existing prepayment credit to the assignable pension cost as of the first day of the plan year regardless of whether a cash contribution is made, and then to establish a new payment credit for any cash contributions made to the plan. The application of prepayment credits in this fashion is not required under the CAS rules, and this approach may result in lower reimbursement under CAS as the quarterly interest adjustments may not apply due to the prepayment credit being applied as of the beginning of the year. In addition, we think it would be beneficial if examples were included which show both the creation of a new prepayment credit (in particular, what interest rate is credited for the remainder of the year in which it is first created) as well as the use of an existing prepayment credit.

Actuarial Value of Assets (AVA)

Also in the example contained in proposed section 412-60(b)(1), the assets are shown separately for each of the segments and an aggregated prepayment credit is shown that is available to all segments. While there are many contractors that maintain the actuarial values of assets in this fashion, there are also many contractors that maintain their prepayment credits on a segment basis. In these situations, contractors often determine their actuarial value of assets by including a portion the prepayment credit in the calculation of the asset value for each segment, and then subtract it off at the end. This treatment parallels the way that the actuarial value of assets is calculated under ERISA, and can result in some differences in the actuarial value of assets.

We believe that clarification is needed as to whether the NPRM requires a change to this method, as it is our experience that numerous contractors use a method where the accumulated prepayment credits are maintained separately for each segment. We also believe that if this is not clearly stated as being an illustrative example or a required change, confusion and disputes related to the methods being used may result.

Segment Closing Calculations

Lastly, we suggest that segment closing calculations should be based on the difference between the minimum accrued liability (MAL) and the market value of assets (MVA). The MAL should be calculated based on the same methodology as the contractor has used as of the most recent valuation, based on interest rates that would have applied as of the segment closing date. The issue that we see with using the actuarial accrued liability (AAL)

is that this would serve to reverse all of the harmonization with PPA that had previously occurred. Looking from a theoretical standpoint, a segment closing should be based on a relatively risk-free basis, which essentially calls for the MAL to be used. If a contractor wishes to assume risks inherent in the investment of assets on a greater risk basis, then the contractor should absorb any losses as well as any gains that might arise.

Conclusion

We recognize the significant effort that has gone into developing the NPRM, and we sincerely appreciate the opportunity to provide comments. We believe that by incorporating these recommended modifications to the NPRM, the goal of achieving an appropriate level of harmonization with PPA will be achieved. If you have any questions or would like to discuss any of these items in more detail, please feel free to contact either of the undersigned.

Sincerely,

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Attachment: Hypothetical Illustration of CAS Harmonization Threshold Test

The inclusion of the CAS Harmonization Threshold Test results in a premature reduction in allowable CAS expense in this hypothetical example, resulting in large unreimbursed prepayment credits:

With Harmonization Threshold Test						
Year	CAS Expense Based on AAL	PPA Contribution	Harmonization Threshold Test Met?	CAS Expense Based on MAL	Final CAS Expense*	BOY Prepayment Credit
1	105	150	Yes	137	137	-
2	105	150	Yes	137	137	14
3	105	150	Yes	137	137	28
4	105	150	Yes	137	137	44
5	105	150	Yes	137	137	60
6	105	150	Yes	137	137	78
7	105	150	Yes	137	137	96
8	105	100	No	137	105	116
9	105	100	No	137	105	117
10	105	100	No	137	105	119

If the CAS Harmonization Threshold Test is eliminated, the harmonized CAS expense applies beyond the seven-year PPA funding period, which helps avoid large, unreimbursed prepayment credits. (Note: only the Final CAS Expense and the Prepayment Credit in the last three years differ from the previous chart):

Without Harmonization Threshold Test						
Year	CAS Expense Based on AAL	PPA Contribution	Harmonization Threshold Test Met?	CAS Expense Based on MAL	Final CAS Expense*	BOY Prepayment Credit
1	105	150	N/A	137	137	-
2	105	150	N/A	137	137	14
3	105	150	N/A	137	137	28
4	105	150	N/A	137	137	44
5	105	150	N/A	137	137	60
6	105	150	N/A	137	137	78
7	105	150	N/A	137	137	96
8	105	100	N/A	137	137	116
9	105	100	N/A	137	137	83
10	105	100	N/A	137	137	49

*** For illustrative purposes, it is assumed that the sum of the MAL and MNC exceeds the corresponding sum of the AAL and the normal cost in all years.**