18 Loeb & Abel (UofB Law School)
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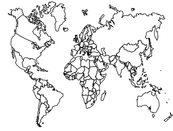

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July 9, 2010

Mr. Eric Shipley
Project Director
Cost Accounting Standard Board
Office of Management and Budget
725 17th Street, NW
Room 9001
Washington, D.C. 20503

Via: E-Mail and FAX to 202-395-5105

Re: CAS Pension Harmonization Proposed Rule – Public Comment (75 *Fed. Reg.* 25982, May 10, 2010)

Dear Mr. Shipley:

I want to thank the Cost Accounting Standard (CAS) Board for this opportunity to comment upon the proposed rule entitled "Harmonization of Cost Accounting Standards 412 and 413 with the Pension Protection Act (PPA) of 2006".

By way of background, these comments represent my own views as Adjunct Professor of Government Contract Law at the University of Baltimore School of Law, and as the former Executive Secretary and Counsel of the Cost Accounting Standards (CAS) Board (1991-2005). They should not be construed as representing the views of any agency of the U.S. Government. I am also authorized to state that these views represent those of Rein Abel, PhD, formerly Director of Research of the CAS Board (1991-2005) and former Professor of Accounting at the Wharton School of Business at the University of Pennsylvania.

Our primary concern with the proposed rule is that the CAS Board is straying from the intent and historical precepts of contract cost accounting and veering toward tax-driven cash accounting. In my November 3, 2008 comment letter regarding the ANPRM (73 *Fed. Reg*. 51261, Sept. 2, 2008), Dr. Abel and I urged the Board to revisit its stated goals and objectives. Our concern remains that the basic purpose of CAS, which differs from those of other accounting standards and rules, may be lost in the technical and actuarial minutiae of the rule.

In the Board's preamble to the proposed rule it is suggested that a commenter urged the Board to re-examine its "Statement of Policies, Objectives and Concepts". To the extent that the Board may have been referring to the letter submitted by Dr. Abel and me, we were perhaps misinterpreted. We did not, and do not, advocate that the Board revamp its Statement of Objectives, Policies, and Concepts – May 1992 (57 *Fed. Reg*. 31036, July 13, 1992). We do, however, believe that the Board should review the goals and objectives, which have guided the Board's development of Standards for many years, as they may inform the proposed "Harmonization Rule".

Specifically, we are mindful of contractors' concerns about greatly extended delays in recouping required contributions to qualified defined benefit pension plan trusts. In this regard, we applaud the Board for not simplistically equating contract pension cost with the Employees' Retirement Income Security Act (ERISA) minimum required contributions. If Congress believed such a linkage was appropriate, the PPA would have said so. Instead, Congress only asked that the Board "harmonize" the CAS pension cost accounting rules with the PPA's minimum required contribution formula.

Reviewing the other extreme of this line of reasoning argument, the Board has wisely stated that it does not agree with the position of some in government that CAS 412 and 413 are already in harmony with the PPA. This flawed logic is premised on the false notion that over time cash outlays and cost recoveries will converge, and if interrupted, any difference would be recoverable through means of a CAS 413-50(c)(12) segment closing adjustment.

In order to temper the many flawed assertions made by parties during the long development of this rule, it may be useful for the Board to review and state its current views on the relationship between contract cost accounting for pensions and the tax-driven requirements for cash contributions to pension plan trusts.

In the January 18, 1970 "Comptroller General's Report on the Feasibility of Applying Uniform Cost Accounting Standards to Negotiated Defense Contracts", GAO B-39995(1), prepared in response to Pub1ic Law 90-370, the Comptroller General addressed the distinct mission of cost accounting standards vis-à-vis financial reporting and tax rules. (See Chapter 1, Introduction – Pages 7 through 9).

That Report states:

> The following are not adequate for contract costing because they have been designed for different purposes.
>
> --Generally accepted accounting principles.
> --Regulations of the Internal Revenue Service.
> --Regulations of the Securities and Exchange Commission
> --Rules adopted by the Renegotiation Board.
>
> Generally accepted accounting principles are concerned primarily with those reports of financial condition and results of total operations for a company, developed principally for stockholders and others interested in the financial condition and operating results of the company as a whole. Such principles are directed at cost allocations between fiscal years so that a company's net income is fairly stated for each successive year. Except as may be necessary for determining the amount of inventory reported in the contractor's balance sheet, they do not go into such details as cost allocations between products and services within a fiscal year; for example, indirect cost distributions between Government contracts and other work of the contractor.
>
> Consequently, "generally accepted accounting principles" are being called upon by ASPR and the FPR to serve a function they were never intended to serve. There are many indirect cost allocation methods available and in use today; however, generally accepted criteria for each method used in specific circumstances have not been developed or established. Hence, even in the valuation of inventories, there is a need for specific criteria for the indirect cost allocation methods used in contract costing.
>
> Regulations of the Internal Revenue Service are intended to implement the laws in taxing the income of corporations and individuals. Tax laws in addition to raising revenue, are intended to achieve a variety of social goals quite foreign to the purposes of contract costing. In addition, tax assessment and collection are continuous so that, except for differences in tax rates, shifts of income or expense from one year to another generally do not have a significant effect on total tax paid over a period of time. However, similar shifts of costs from one year to another, as well as other shifts of costs, could have a decided impact on the costs chargeable to a Government contract.

This underlying conceptual framework for the creation of the CAS is reiterated in the CAS Board's "Statement of Objectives, Policies, and Concepts". In the discussion on CAS in "Relationship to Other Authoritative Bodies", it states

> A number of authoritative bodies have been established to issue pronouncements affecting accounting and financial reporting. The Cost Accounting Standards Board views its work as relating directly to the preparation, use, and review of cost accounting data in the negotiation, administration, and settlement of Government contracts …

> The accounting areas of interest to the Board that are also of interest to others for financial and tax accounting purposes are: (1) definition and measurement of costs; (2) assignment of the cost of resources consumed to time periods; and (3) allocation of direct labor, direct material, and indirect costs to the goods and services produced in a period.
>
> The Cost Accounting Standards Board seeks to avoid conflict or disagreement with other bodies having similar responsibilities and will, through continuous liaison, make every reasonable effort to do so. 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 nature of the Board's authority and its mission, however, is such that it must retain and exercise full responsibility for meeting its objectives.

In the ANPRM, the Board discussed the distinctly different purposes of the CAS, the Employees' Retirement Income Security Act (ERISA) and generally accepted accounting principles (GAAP) by stating:

> The Board believes that the measurement and assignment of pension cost will continue to be based on reasonable, long-term assumptions. Unlike the CAS, the purposes of the PPA minimum required funding and generally accepted accounting principles (GAAP) expense disclosures are unconcerned with cost predictability and stability across periods. The PPA is concerned that plan assets can adequately liquidate the settlement liability under current market conditions. GAAP is concerned with reporting the results of corporate operations during the current period, including changes due to market conditions. CAS 412 and 413 are concerned with (i) assigning pension costs to periods that reflect the going-concern nature of the contractor and pension plan, (ii) the long-term pension funding and investment decisions of the contractor sponsoring the plan, and (iii) minimizing volatility to enhance predictability for forward pricing.

We were pleased that the Board recognized the unique purpose of the CAS as demonstrated by the statement under *Topic C: General Comments on Differences between CAS, GAAP and ERISA (PPA)***.** The introduction to this topic clearly states:

> The SDP and ANPRM discussed the similarities and distinctions between the goals and measurement criteria of CAS, GAAP and ERISA. The unique purpose and goal of the CAS was determinative of the Board's proposed harmonization approach.

And in its response to comments the Board went on to say:

> The goal of the ANPRM was to maintain predictability for cost measurement and period assignment while providing for reconciliation, i.e., recovery of required contributions within a reasonable timeframe. The divergence of GAAP and ERISA from CAS is primarily due to the adoption of "mark-to-market" cost measurement, which can be disruptive to the contract costing/pricing process.

The Board remains cognizant of the following key distinctions between ERISA, GAAP and CAS regarding funding of pension cost:

- ERISA's minimum funding is concerned with the funding of the current settlement liability.

- GAAP is not concerned with funding, but rather with the disclosure of the results of operations in the current market environment.

- CAS continues to be concerned with the Government's participation in the funding of the long-term pension liability via a continuing (going concern) relationship with the contractor. CAS 412 and 413 are used to develop data for forward pricing over multiple years, and is not just concerned with the current environment.

The Board wishes to retain the contractor's flexibility to choose the actuarial cost method it deems most appropriate for its unique pension plan. While the CAS permits the use of any immediate gain cost method, most contractors already use the projected unit cost method, which is required by ERISA and GAAP and compliant with CAS 9904.412-40(b)(1). As long as the current CAS permits the use of methods required by the PPA there is no reason to revise the CAS to be more restrictive. Furthermore, the Board notes that for CAS purposes a contractor may use the same actuarial cost method and assumptions, except for the long-term interest assumption, as used to value a plan under PPA that is not "At Risk." (With the passage of the PPA, ERISA no longer computes liabilities and normal costs using long-term interest assumptions.)

The Board believes that the proposed 10-year amortization of the gains and losses will sufficiently harmonize CAS with the PPA while providing acceptable smoothing of costs between most periods. The Board notes that the plunge in stock market values in the latter half of 2008 demonstrates how quickly things can change between periods, but remains confident that the aberrant market losses for 2008 and early 2009 will be adequately smoothed using 10 versus 15 years.

As the Board's response notes, strictly tying pension accounting to settlement liabilities and current fair market values will cause volatility that will be counterproductive to predictability and disrupt the contract forward pricing process. Contract price predictability must remain a critical concern for the Board.

Some of the provisions contained in the proposed rule would appear to improve contract cost recognition and seem to fulfill Congress' desire for "harmonization". They are:

- Accelerated gain and loss recognition to limit the period of delay.
- Allowing projection of flat dollar benefits to improve full costing and provide similar treatment as afforded dollar-related benefits.
- Guidance on contributions made after the end of a plan year.

- Interest on prepayment credits based on the trust fund's return on investment so that the contractor's investment in the fund via excess contributions shares on an equal basis with funds reimbursed by the Government.

We do however have some specific concerns with the proposed rule:

1. Adoption of settlement accounting for costing of ongoing pension plans.

The long standing concept of accounting is that pension plans are presumed to continue absent evidence to the contrary. We understand that actuaries include assumptions concerning settlement payment (lump sum) elections by terminating and retiring employees – thus the likely risk of paying the extra settlement cost is already anticipated in actuarial measurements. Furthermore, the expected return on investment should reflect a contractor's investment policy for the plan, rather than theories of financial economics that are in vogue.

2. Excessive illustrations that do not focus on unique features of the rule and that could imply acceptance of tax-accounting.

The proposed CAS 9904.412-60 harmonization illustrations include many examples of how the ERISA contribution will be determined. Such determinations are beyond the scope of the CAS. Also, as the Board noted in the preamble to the proposed rule, ERISA is prone to frequent change so these illustrations may soon be obsolete and confusing. These illustrations were useful for an NPRM that addresses such a complex subject, but are inappropriate for a final rule. Accordingly, they should be removed.

3. Reintroduction of sudden changes in cost projections by eliminating the ACL buffer proposed in the ANPRM moves away from predictability.

Predictability should be a major concern for CAS and the Board should seek to minimize sudden windfalls for either party. The ANPRM proposed an Assignable Cost Limitation (ACL) based on assets in excess of 125% of a plan's liability. This would prevent plans that are close to full-funding from having their pension costs suddenly drop to zero or else suddenly incur unexpected large pension costs. The "cliff effect" of the now proposed ACL is difficult to predict or forecast. This is of particular concern with "frozen plans" that have no normal cost. Either event is disruptive of the forward pricing process and predictability. We understand that as assets exceed the liability, the amortization of the asset surplus dampens the pension costs and drives it towards zero.

Nevertheless, the now proposed ACL does not protect the government when a contractor's plan accumulates and maintains a large surplus for many years. The CAS 990.4412-50(c)(2)(i) zero dollar floor prevents recovery of any credits generated by the surplus. We recommend that the Board consider reinserting the buffer ACL into the final rule.

4. Exemption for mandated benefit curtailments and proposed "post-segment closing" adjustments.

We agree that benefit curtailments mandated by the PPA should not trigger a segment closing adjustment if the segment and the contracts continue. Treating the curtailment as an actuarial gain is a pragmatic solution, but if the net pension cost is a credit amount, then the CAS 412-50(c)(2)(i) zero dollar floor prevents recovery of the surplus.

The proposed coverage at CAS 9904.413-50(c)(12)(ix) seems to suggest a means for accounting for the payment of a 413-50(c)(12) adjustment credit to the Government if immediate recognition is required – but what about subsequent gains? The Board could use the conceptual framework of 413-50(c)(12)(ix) to construct a rule to recover semi-permanent surpluses and "deactivate" the 412-50(c)(2)(i) floor under certain circumstances. However, subparagraph (ix) and the issue of permanent surpluses should be addressed in a case on segment closings as this may be beyond the scope of the current case.

5. Effective Date and Phase-in of settlement liability to address budgetary concerns.

The Board states that equitable price adjustments are a matter of CAS administration and outside the scope of this case. But this is also true of procurement budget concerns. The Board introduces a "phase in" of the "Harmonization Rule" because of expressed concerns regarding government agency budgets and explains that the transition rule is designed to "manage possible increases in contract costs" and that "the proposed phase-in provisions are intended to make the possible cost increases due to harmonization more manageable for the procuring agencies."

We strongly disagree that this line of reasoning is appropriate for an accounting rule, although we are quite sensitive to any budgetary concerns. We suggest that rather than phrasing the basis for the transition provisions in terms of budgetary concerns, the Board may wish to discuss this issue in terms of the need for a phase-in based on contract price predictability and the impact of large accounting changes on forward pricing. It is the lack of predictability in contract costs and prices that contractors and the Government find so disruptive to the procurement process. Ultimately, overall contract costs are likely to remain unchanged as a result of the rule. What will change is the period assignment of these costs, and government agencies' concerns are ultimately focused on *pricing predictability*. Remaining focused on predictability (consistency of costs between periods) eases the non-CAS administrative concerns with budgeting and equitable price adjustments.

Conclusion

Dr Abel and I hope the Board finds these comments useful. In addition to the specific recommendations made above, the CAS Board may wish to consider its overall objectives when dealing with the issue of contract cost accounting for pensions. As the Board has had to respond to changes in pension costing due to changes in law, this has had the effect, in some instances, of creating a regulatory scheme that is not always consistent in approach. Obviously, this is the antithesis of what proper accounting should be. Any review that may be undertaken should emphasis and reaffirm the important role of predictability as a specific goal or objective of CAS.

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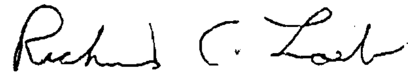
Thank you for your consideration of these comments.

Sincerely,



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