



September 5, 2013

Sent via e-mail to casb2@omb.eop.gov

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

Dear Sir or Madam,

Reference: Fact-finding—CAS 413 Pension Adjustments for Extraordinary Events

Aon Hewitt has prepared this letter in response to the request for public comments by the Cost Accounting Standards (CAS) Board as published in the *Federal Register* on July 8, 2013. We appreciate the opportunity to provide comments to the CAS Board as it develops its Staff Discussion Paper on CAS 413 Pension Adjustments for Extraordinary Events.

Who We Are

Aon Hewitt empowers organizations and individuals to secure a better future through innovative talent, retirement and health solutions. We design and execute, as well as advise on, a wide range of solutions that enable organizations to cultivate talent to drive organizational and personal performance and growth, navigate retirement risk while providing new levels of financial security, and redefine health solutions for greater choice, affordability, and wellness. Aon Hewitt is the global leader in human resource solutions, with over 30,000 professionals in 90 countries serving more than 20,000 clients worldwide. We offer actuarial consulting services to many of the largest government contractors in the U.S., including several of the top 20 Department of Defense contractors. For more information on Aon Hewitt, please visit www.aonhewitt.com.

General Comments

Many defense contractors are working hard to control costs and stay competitive in the current business and economic environment,¹ and the existing CAS 413 has been an obstacle to effective management of pension costs. Many Government contractors would like to eliminate future pension accruals but do not want to engage in lengthy litigation over a one-time CAS 413-50(c)(12) adjustment and/or go through a costly exercise to determine the Government's share of the adjustment. Amending CAS 413 to remove benefit curtailments from one-time adjustments would enable contractors to stay competitive and control cost and risk.

¹ Defense contractors are not alone in this effort. According to Aon Hewitt research, close to 100 *Fortune 500* companies froze their primary salaried pension plan in the period from 2004 to 2012. Many factors contributed to this trend, but the pace of plan freezes increased after the enactment of the Pension Protection Act (PPA) in 2006.



Conversely, CAS 413 adjustments should be retained for plan terminations and segment closings. The finality of these events warrants a one-time true-up of plan costs, regardless of the ongoing contracting relationship.

The remainder of this letter will address specific issues raised in the CAS Board's request for comments published in the *Federal Register* and subsequent public meetings.

Benefit Curtailments

When the existing CAS 413 provisions were written in the 1970s and amended in 1995, benefit curtailments (i.e., full plan freezes) were relatively rare events. A plan freeze was likely a precursor to a full plan termination or subsequent corporate transaction, making it reasonable to treat benefit curtailments in the same manner as a plan termination or a segment closing.

In today's conditions, defined benefit plan freezes are becoming more common as contractors seek to reduce volatile costs of defined benefit plans and perhaps replace them with more stable defined contribution plan costs. This is a strategic business decision related to the delivery of retirement benefits which does not alter the ongoing Government contracting relationship.

In this situation, the contractor continues to perform Government contracts and it is unnecessary to determine a one-time adjustment due to this event. A benefit curtailment is nothing more than a negative plan amendment taken to the extreme, where the benefit formula is reduced to zero for future accruals.

We recommend that benefit curtailments be excluded from the one-time adjustment provisions. Instead, they should be treated as plan amendments in accordance with the contractor's disclosed cost accounting practice.

Plan Terminations and Segment Closings—Actuarial Assumptions

As noted above, CAS 413 adjustments should be retained for plan terminations and segment closings due to the finality of these events.

In general, the assumptions used to determine the plan liability under a CAS 413 adjustment should be consistent with the nature of the underlying event:

- For plan terminations, the current rule specifying that the "actuarial accrued liability shall be measured as the amount paid to irrevocably settle all benefit obligations or paid to the Pension Benefit Guarantee [sic] Corporation" should be retained. The amount paid to irrevocably settle the obligation is the best true measure of cost.
- For segment closings, CAS 413 should explicitly require the actuarial assumptions to be consistent with the expectations related to the event. For example, a closing or sale of a division may lead to accelerated retirements. Given the finality of the adjustment, the accelerated retirements should be reflected in the calculation of the segment liability for CAS 413 adjustment purposes.



In recognition of the objectives of harmonization and consistency with ongoing CAS 412 cost recognition, the minimum actuarial liability (as defined in CAS 412-50(b)(7)) should be the liability basis for determining the CAS 413 adjustment in segment closings. Ignoring periods with legislative or regulatory relief (e.g., the Moving Ahead for Progress in the 21st Century Act or “MAP-21”), the minimum actuarial liability most closely represents the liability on a current market value basis and using it would be consistent with the current requirement to use the market value of assets in the determination of the CAS 413 adjustment.

In addition, significant one-time plan termination adjustments can be reduced if an Assignable Cost Limitation buffer would be allowed under CAS 412-50(c)(2)(ii). The addition of a buffer would allow for a more systematic path to plan termination and avoid large cost disconnects that would be difficult to budget for. The addition of such a buffer would be consistent with the direction and spirit of PPA harmonization.

Other Settlement Events

In the current environment, there are many common settlement events that fall short of a full plan termination or segment closing. These events include in-plan or out-of-plan annuity purchases and lump sum windows that provide an opportunity for plan sponsors to reduce ongoing obligations and risk within their plan(s). It is not appropriate or necessary to include these types of events under CAS 413 adjustments. These types of events are part of the financing strategies of contractors/plan sponsors, and the current CAS 412 and 413 rules provide an appropriate framework for recognizing costs after the implementation of these events.

Plan Terminations and Segment Closings—Issues Related to CAS 413-50(c)(12)(iii)

The CAS Board needs to provide further guidance and/or examples for determining a segment closing date or plan termination date, particularly the circumstances that may result in inequitable calculations. In general, the plan termination date is the date upon which the last obligation is settled, but this concept should be memorialized in updated rules. For segment closings, bright-line tests and/or illustrative examples should be included to provide a better framework for negotiating segment closings.

Segment Closings—Issues Related to CAS 413-50(c)(12)(v)

In situations where only some of the pension plan assets and actuarial accrued liabilities of a closed segment are transferred to a successor contractor, Internal Revenue Code (IRC) section 414(l) rules are likely to cause a mismatch between the assets accumulated in the segment and the assets required to be transferred to the new contractor.

There are two situations to address, depending on whether the assets that are transferred under IRC section 414(l) are more or less than the assets being held in the segment under CAS 413 rules. Our view of how the transaction should be recognized is illustrated in the following two examples.

The illustrations pertain to a situation where a segment within a plan is closed due to the sale of a division by Contractor A to a successor contractor (Contractor B). The segment has \$100 in liabilities (\$100 of which will be transferred) and \$70 in assets accumulated in the segment.



Transferred Assets Exceed Segment Assets

In this example, \$75 in assets is required to be transferred to the new contractor. The situation is summarized in the following table:

	Prior to Sale	After Sale	
	Contractor A	Contractor A	Contractor B
Liabilities	\$100	\$0	\$100
Assets	\$70	\$(5)	\$75
Unfunded Liability	\$30	\$5	\$25

A CAS 413 adjustment of \$5 (a segment closing charge) is recognized at Contractor A, and the Government will be required to pay Contractor A \$5 (subject to the CAS 413-50(c)(12)(vii) fraction). The Government will benefit from the \$5 payment through reduced costs (reduced unfunded liability) at Contractor B. Presumably, Contractor B will retain the existing amortization schedule of the original unfunded liability from Contractor A. The \$5 adjustment required due to the IRC section 414(l) mismatch should be amortized over 10 years consistent with other actuarial gains/losses under harmonized CAS 412 rules.

Transferred Assets Are Less Than Segment Assets

In this example, \$65 in assets is required to be transferred to the new contractor. The situation is summarized in the following table:

	Prior to Sale	After Sale	
	Contractor A	Contractor A	Contractor B
Liabilities	\$100	\$0	\$100
Assets	\$70	\$5	\$65
Unfunded Liability	\$30	\$(5)	\$35

A CAS 413 adjustment of \$5 (a segment closing *credit*) is recognized at Contractor A, and Contractor A will be required to pay the Government \$5 (subject to the CAS 413-50(c)(12)(vii) fraction). Contractor A will benefit from the \$5 payment by retaining the \$5 in the plan. Presumably, Contractor B will retain the existing amortization schedule of the original unfunded liability from Contractor A. The \$5 adjustment required due to the IRC section 414(l) mismatch should be amortized over 10 years consistent with other actuarial gains/losses under harmonized CAS 412 rules.

Plan Terminations and Segment Closings—Issues Related to CAS 413-50(c)(12)(vi)

In many cases, contractors have long and complex histories in providing services to the Government. Mergers and acquisitions, segment combinations and splits, other changes in cost accounting, and incomplete or inadequate records can make determination of the Government's share of a CAS 413 adjustment expensive and time-consuming.



The current rule provides that the Government share can be determined using a fraction that is “representative of the Government’s participation in the pension plan.” While this rule is helpful in spirit, it does not provide enough guidance in determining what can or should be considered representative. To eliminate uncertainty, it would be helpful if safe harbor thresholds were specified. For example, pension plan costs determined over a period of at least 10 years would be considered representative if the contractor has had a consistent contracting relationship over that period (at least X% of sales derived from Government contracts throughout the period).

In addition, it would be helpful if an even simpler rule were put in place for *de minimis* adjustments. For example, if an adjustment represents less than X% of the sales derived from Government contracts, the fraction under CAS 413-50(c)(12)(vi) can be determined using current and/or prior year cost data instead of the full (or safe harbor) history.

Plan Terminations and Segment Closings—Issues Related to CAS 413-50(c)(12)(vii)

The CAS Board’s request for comments published in the *Federal Register* posed several questions about how adjustment debits (charges) or credits should be reflected in ongoing costs. Following is a summary of how we recommend the adjustments should be handled.

Generally speaking, any adjustment debit (*charge*) created under CAS 413 will require a one-time payment from the Government to the contractor equal to the Government’s share of the charge. In this case, the payment should be paid into the pension trust and credited to the segment assets. In cases where an amortization agreement can be negotiated, the contractor would set up an unfunded accrual (charge base) equal to the *gross* adjustment charge amount (prior to the application of the fraction determined under CAS 413-50(c)(12)(vi)). The charge base would be amortized over the agreed upon period.

Conversely, an adjustment *credit* under CAS 413 will require a one-time payment from the contractor to the Government equal to the Government’s share of the credit. Generally speaking, this payment will not (and cannot) be paid from the trust assets but will need to come from general contractor funds. From a plan perspective, the segment assets will be reduced by the gross amount of the CAS 413 adjustment and a prepayment credit will be created equal to the same gross amount. Costs will continue to be developed under the segment using the reduced assets and assigned to contracts, as appropriate. The prepayment credit will be available to cover those costs as they are recognized.

Working Group Question—What Is the Government’s Responsibility for Ongoing Costs?

The Working Group asked if the Government has an ongoing responsibility to reimburse pension costs in situations where events result in a plan segment that is no longer associated with current contract work or a plan segment that only has retired and vested terminated members remaining. These were referred to as “orphaned” segments.

The original intent of CAS 412 and 413 was to account for the cost of pensions as an allowable cost of doing business. Just as the cost of compensation paid to active employees was allowable, so was



the cost of deferred compensation to be paid to these same employees in the form of retirement benefits considered allowable. It is appropriate for the Government to honor this commitment and continue to reimburse the costs of pensions for these orphaned segments by including such costs in corporate overhead if they cannot otherwise be appropriately assigned.

A question was also raised about whether the Government should bear the risk of the contractor's investment decisions, specifically related to a plan sponsor's appetite for risky investments or lack of immunization through liability-driven investments. In our view, there has been a longstanding recognition that the Government has relied on the plan sponsor's role as a plan fiduciary to ensure that the plan's assets are invested prudently. This relationship has been in place for decades, and it remains effective today.

Closing

We want to express again our thanks to the CAS Board for taking on these important issues. This is a critical time for pension plan sponsors as they continue to address the overall economic, competitive, and human resource challenges of the 21st century. Government contractors are not immune to these challenges, and the changes and clarifications being discussed under CAS 413 will enable them to continue to meet the needs of the U.S. Government and national defense.

If you have any questions or comments, please contact the undersigned at the telephone number or email address provided below.

Sincerely,

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