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Cost Accounting Standards Board
Office of Federal Procurement Policy
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Room 9013
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Re: Fact finding – CAS adjustment for extraordinary events

We appreciate the Cost Accounting Standards Board's willingness to consider comments on and possible revisions to the current standard's method of determining pension cost adjustments when an extraordinary event occurs. We understand that due to the technical and complicated nature of the other changes that were already being introduced by the CAS Harmonization Rule, a decision was made to address segment closing adjustments under a separate project. Since the government contracting community is now operating under the Harmonization Rule, and the segment closing issue remains an open item that still needs to be addressed in order to complete the Harmonization mandated by the Pension Protection Act, we would like to offer our thoughts and suggestions on how to change segment closing calculations to fit the theme of Harmonization. We are offering these thoughts as actuaries and pension specialists who practice in the defense industry rather than acting as agents of our employers, so this paper may, or may not, represent the views of our employers.

Under the current Harmonized CAS there are two issues related to segment closings. One issue is the calculation of the liability that is included in the amount of the segment closing adjustment, and the other issue is the specific events that trigger a segment closing adjustment.

Regarding the pension liability that is reflected in a segment closing calculation, in the absence of a plan termination, the regulations presently require the calculation to be made using the actuarial accrued liability based on the accrued benefit cost method (AAL). The AAL is based upon long-term actuarial

assumptions. As explained further below, we believe that the resulting calculation 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 may be useful. The CAS currently provides for two measures of assets and two measures of liabilities. The various asset and liability measurements have different purposes:

• Smoothed measurements enhance predictability. 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. Because of this smoothing effect neither the AAL nor the AVA provide an accurate snapshot of a plan's funded status at any given point in time (i.e., segment closing).

• Unsmoothed measurements provide accurate point in time valuations. The market value of assets ("MVA"; see id.), by its very nature, precisely measures assets at a point in time. Similarly, the minimum actuarial liability ("MAL"), as defined in CAS 412-50(b)(7)(ii)(A), 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," and is therefore a point-in-time measurement. Because these measurements capture the prevailing economic environment at a given point in time, the MVA and the MAL provide the most accurate measure of a plan's funded status at that point in time.

The CAS currently compares the unsmoothed MVA against the smoothed AAL to determine the segment closing adjustment (i.e., the difference between the two amounts). This difference can fluctuate greatly and consequently reward one party while penalizing the other in an arbitrary manner. It also seems counterintuitive to use settlement assumptions during the going-concern phase of a segment while going-concern assumptions are used in the settlement calculation made in connection with a segment closing. Contrary to the wishes of Congress, we note that CAS 413 puts contractors in a position where the only way to achieve true "harmonization" upon plan curtailment is to fully terminate and annuitize the pension plan (in the case of a plan termination liabilities are measured by the cost of annuities which are more comparable to the MAL than the AAL). The current CAS effectively penalizes contractors who do not terminate

their plans and choose to retain responsibility for plan assets and liabilities when a curtailment occurs.

It is equally important to recognize that the current treatment effectively prevents harmonization. Coincident with directing the harmonization of CAS with the Pension Protection Act (PPA), Congress established the "funding target" ("FT") as the optimal level of pension funding. Because the FT and the MAL are similar at segment closing, the PPA essentially contemplates that assets equal to the MAL would have been accumulated at the segment closing. By basing the segment closing on the AAL rather than the MAL, however, the current CAS 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. The net result is that the CAS Harmonization rule would be reduced to a temporary provision, initially resulting in contract cost increases to better align with the PPA but later reversing those increases when a segment closing is triggered. 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. This conflicting result could be remedied by changing the segment closing calculation.

Clearly the current segment closing provisions do not achieve harmonization. As previously mentioned, 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 will likely 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 by terminating their pension plans 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, as well as the Contractor's disclosed practices.[1] This would ensure that both assets and liabilities used for segment closing

[1] In order to ensure that assets and liabilities reflect the same underlying economic conditions, we would suggest that spot interest rates (as opposed to a rates averaged over a period of time) be used in determining the liability for the segment closing calculation regardless of the rates used for ongoing MAL purposes.

purposes reflect consistent, market-based assessments of the prevailing economic conditions. The segment closing measure would be less volatile than in the current CAS and the potentially wide-reaching problems resulting from "deharmonization" at segment closing would be eliminated.

Turning to the second issue, we also believe there should be a change to the named events which trigger a segment closing calculation. In particular, a curtailment of benefits should not be considered an event that would result in a segment closing calculation or a segment closing adjustment. In cases where a segment is not closed and the pension plan is not terminated, and there is continuing performance on Government contracts, a curtailment of benefits should not result in a segment closing calculation. In such cases a segment closing adjustment would only result in an unnecessary obligation that would be levied against either the Government or the contractor, which would probably not serve the interests of either party. Since there will continue to be ongoing pension cost adjustments due to actuarial gains and losses in cost accounting periods subsequent to the curtailment, it would be much more practical to reflect any unfunded (or overfunded) liabilities at the time of curtailment in any pension costs subsequent to the curtailment. Continuing performance on Government contracts would readily lend itself to this remedy.

If this change is not made, it might incent pension plan sponsors to terminate a pension plan after a benefit curtailment, which could result in a significant liability for the Government. That might be the only way for sponsors who are forced to perform a segment closing calculation to have the amount determined based on prevailing settlement costs. This seems like an undesirable and unintended consequence that could be avoided by making this change.

We recognize that if curtailments are no longer considered a trigger for a closing adjustment, the issue of ensuring equitable cost allocations should be addressed. Under the current standard, allocations are based on the pay or headcount of active participants. At least for the first few years after a curtailment due to a benefit freeze, there will likely be a sufficient number of active employees who are also plan participants to permit a reasonable pay- or headcount-based allocation. Eventually, the number of active employees participating in the plan will decline enough that a pay- or headcount-based allocation no longer works. When that happens, an alternative method might be preferable.

We would like to thank you for your consideration of this very important topic. Since we are not representing any formal organization or any particular company we are providing our individual contact information below.

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