

September 6, 2013

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Cost Accounting Standards Board
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Reference: Fact-finding — CAS adjustment for extraordinary events

We have prepared this letter in response to the request for public comments by the Cost Accounting Standards Board (“the Board”) as posted in the Federal Register Notice (FRN) on July 8, 2013. We appreciate the opportunity to provide comments to the Board as it conducts its fact-finding for the development of a Staff Discussion Paper (SDP) on CAS 413 Pension Adjustments for Extraordinary Events.

Towers Watson is a leading global professional services company that helps organizations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of benefits, talent management, rewards, and risk and capital management. Our focus is on giving clarity to make the right decisions and take the right actions.

We consult for a number of organizations that are subject to CAS and the Federal Acquisition Regulations (“FAR”). Over the years, we have been actively participating in the CAS rulemaking process impacting pension plans. We trust that the Board finds our participation helpful in the process.

We have included comments in this letter for one or more of the following reasons:

- The topic was raised in the FRN and/or discussed at the public hearings.
- Current provisions are inadequate in addressing the current and potential future state of pension plans, e.g., fewer active participants and increasing numbers of inactive participants.
- Current provisions are not sufficiently clear, thus leading to areas of contention for the government and contractors, or have the potential to be areas of contention in the future unless clarity and guidance is provided by the Board.

Issues Noted in the Federal Register NoticeCAS 413-50(c)(12) Applicability

One of the issues posed in the FRN is whether benefit curtailments should be excluded from events that require a segment closing adjustment of previously-determined pension costs. Current CAS defines a benefit curtailment as “an event, e.g., a plan amendment, in which the pension plan is frozen and no further material benefits accrue.”

With benefit curtailments, there is still an ongoing contractual relationship between the contractor and the government and there will still be ongoing costs, unlike in the case of a true segment closing or a plan termination. We believe the inclusion of benefit curtailments may be unnecessary, takes away an option for contractors in managing their retirement risks and may only complicate contract pricing. If a plan is frozen, an adjustment to previously-determined pension costs would naturally occur in cost-type contracts, even without a segment closing adjustment. Ongoing costs will naturally drop because future normal costs will be zero and also due to the resulting negative plan amendment base (if any).

We note that under current CAS, an amortization of the government’s share of the segment closing adjustment is allowed under CAS 413-50(c)(12)(vii), in lieu of an immediate charge or credit. Requiring a determination of the adjustment when the plan is frozen and then amortizing the government’s share is similar to amortizing the impact of the freeze as a negative plan amendment, except the latter is not disruptive to the contracting process as well as the annual valuation process.

Thus, we recommend the exclusion of benefit curtailments from events that require a segment closing adjustment of previously-determined pension costs.

CAS 413-50(c)(12)(i) Measurement of Liability

Another issue posed in the FRN is with regard to the measurement of the liability at segment closing.

The possibilities for measurement of the liability include the following; most of these were mentioned at the public hearings:

- the Present Value of Accrued Benefits (PVAB) reflecting the long-term asset return assumption (current CAS);
- the Minimum Actuarial Liability (MAL);
- the PPA Target Liability, which may or may not equal the MAL;
- the PBGC vested benefit liability, used for determining PBGC variable premiums (this ignores the MAP-21 corridor);
- the settlement liability reflecting current lump sum and annuity purchase rates; or
- the liability measured using PBGC plan termination basis, whether or not the plan is actually being terminated.

Note that all of the above apply to qualified pension plans, but not to nonqualified pension plans. As the Board reviews and redefines the appropriate liability for a segment closing adjustment, it will be important to not overlook how the definition would apply to nonqualified pension plans.

In our opinion, a mark-to-market measurement that reflects the amount that would be needed to effectively settle the pension benefits using the interest rate defined in CAS 412-50(b)(7)(iii)(A) would be appropriate. For clarity and to avoid future disputes, we recommend specifying that the applicable interest rate should reflect market rates as of the first of the month immediately prior to the segment closing measurement date.

If the contractor is committed to offering lump sums and/or purchasing annuities within a reasonable time frame after the event that causes the segment closing adjustment, whether or not the plan is being terminated, then the liability to be recognized should reflect such lump sums or purchased annuities just as these would be reflected in measuring liabilities at any other time. For clarity and to avoid future disputes, we believe CAS 413 should be specific about this (perhaps through a CAS 413-60 illustration), and should also clarify that lump sums and annuity purchases are not subject to the phase-in adjustment described in CAS 413-50(c)(12)(iv).

Aside from the interest rate, it would be appropriate to reflect the best available information as of the date of measurement and use assumptions that reflect the expected future experience under the plan for the affected participants. If conditions have changed due to the segment closing event, e.g., retirements are accelerated or more lump sums are paid than otherwise assumed on an ongoing basis, actuarial standards require that actuaries reflect such conditions. Section 3.14 of the Actuarial Standard of Practice (ASOP) No. 4, *Measuring Pension Obligations*, states (emphasis added),

“3.14 Measuring the Value of Accrued or Vested Benefits — Depending on the scope of the assignment, the actuary may measure the value of accrued or vested benefits as of a measurement date. The actuary should consider the following when making such measurements:

- a. relevant plan provisions and applicable law;*
- b. the status of the plan (for example, whether the plan is assumed to continue to exist or be terminated);*
- c. the contingencies upon which benefits become payable, which may differ for ongoing- and termination-basis measurements;*
- d. the extent to which participants have satisfied relevant eligibility requirements for accrued or vested benefits and the extent to which future service or advancement in age may satisfy those requirements;*
- e. whether or the extent to which death, disability, or other ancillary benefits are accrued or vested;*
- f. whether the plan provisions regarding accrued benefits provide an appropriate attribution pattern for the purpose of the measurement (for example, it may not be appropriate if the plan’s benefit accruals are severely backloaded); and*
- g. if the measurement reflects the impact of a special event (such as a plant shutdown or plan termination), the actuary should consider factors such as the following:*
 - 1. the effect of the special event on continued employment;*
 - 2. the impact of the special event on employee behavior due to factors such as subsidized payment options;*
 - 3. expenses associated with a potential plan termination, including transaction costs to liquidate plan assets; and*
 - 4. changes in investment policy.”*

Note that the mark-to-market liability measurement we are recommending, while very similar to the MAL, is not the MAL for ongoing CAS costs. The liability we are recommending will not necessarily have the same interest rate basis as the MAL determined for ongoing CAS costs; it is determined without regard to the PPA interest rate “safe harbor” under CAS 412-50(b)(7)(iii)(B). Also, it is determined without regard to the transition provisions of CAS Pension Harmonization provisions and may not necessarily reflect prior long term assumptions used in determining ongoing costs as provided under current CAS 413-50(c)(12)(i). In fact, we believe CAS 413-50(c)(12)(i) should be amended so that it will not be required for assumptions to be consistent with assumptions being used for determining pension costs in prior valuations, as such assumptions may not necessarily be appropriate. This change would allow the liability measurement to be performed using assumptions that are in line with ASOP No. 4.

Finally, liability measurements are inherently imprecise, and assumptions different from those used by the contractor or the government’s actuary may be just as reasonable. To reduce time-consuming and costly efforts to reconcile, the Board (or the FAR Council) may want to consider setting a specific threshold with respect to an acceptable difference in the contractor and the government’s measurements of the liability for the segment, either expressed in dollars, or as a percentage of the liability, or a combination of both, e.g., the greater of \$1 million or 3% of the liability.

CAS 413-50(c)(12)(ii) Measurement of Assets

Given a mark-to-market liability measurement, we believe it is appropriate to continue with a mark-to-market measurement of assets for segment closing adjustments. Market value should be used, and not a smoothed value. The best available information as of the date of measurement should be used. A valuation of the market value of assets by the trustee as of the segment closing measurement date should not be required; a roll-forward from the most recent trust valuation date, using the expected long-term return on assets based on the allocation of plan assets as of the most recent trust valuation date, should be acceptable. By the most recent trust valuation date, we mean the most recent date that the market value of assets has been provided by the trustee. This could be the first of the month preceding the measurement date for the segment closing event, if monthly trust reports are prepared for the plan.

The issue of incomplete and inadequate historical records on plan contributions, benefits and earnings was posed in the FRN. The issue appears to be relevant only in the context of CAS 413-50(c)(5)(i):

“(5) For a segment whose pension costs are either required to be calculated separately pursuant to paragraph (c)(2) or (c)(3) of this subsection or calculated separately at the election of the contractor, there shall be an initial allocation of a share in the undivided market value of the assets of the pension plan to that segment, as follows:

- (i) If the necessary data are readily determinable, the funding agency balance to be allocated to the segment shall be the amount contributed by, or on behalf of, the segment, increased by income received on such assets, and decreased by benefits and expenses paid from such assets. Likewise, the accumulated value of permitted unfunded accruals to be allocated to the segment shall be the amount of permitted unfunded accruals assigned to the segment, increased by interest imputed to such assets, and decreased by benefits paid from sources other than the funding agency; or”*

If assets for the segment have not been tracked on an ongoing basis because plan costs are determined under composite accounting, we believe historically recreating the assets for the closed segment at the time of the segment closing event is not required. We believe that it is in recognition of the practical challenges of incomplete and inadequate historical data that the option under CAS 413-50(c)(5)(ii) is provided:

- (ii) *“If the data specified in paragraph (c)(5)(i) of this subsection are not readily determinable for certain prior periods, the market value of the assets of the pension plan shall be allocated to the segment as of the earliest date such data are available. Such allocation shall be based on the ratio of the actuarial accrued liability of the segment to the plan as a whole, determined in a manner consistent with the immediate gain actuarial cost method or methods used to compute pension cost. Such assets shall be brought forward as described in paragraph (c)(7) of this subsection.”*

We believe current CAS already provides for determining a segment’s assets at the time of the segment closing event using CAS 413-50(c)(5)(ii), and recreating history is allowed but not required.

CAS 413-50(c)(12)(iii) Measurement Date

This provision of CAS 413 states (emphasis added):

“The calculation of the difference between the market value of the assets and the actuarial accrued liability shall be made as of the date of the event (e.g., contract termination, plan amendment, plant closure) that caused the closing of the segment, pension plan termination, or curtailment of benefits. If such a date is not readily determinable, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date”

In our opinion, this provision needs clarification. Consider the following example: The Board Resolution to terminate the plan is February 1st. The plan is frozen as of April 1st. The plan is terminated on October 1st, with final distribution of assets occurring thereafter. The current provision is unclear as of what date the assets and liabilities for the segment should be determined.

We recommend that the Board specify the measurement date depending on the event that triggers the segment closing adjustment:

- If the segment has been sold or the ownership has been otherwise transferred, the measurement date is the date of the sale or transfer of ownership.
- If the segment has discontinued operations, the measurement date is the date when all operations have essentially ceased.
- If the contractor has discontinued doing or actively seeking government business under contracts subject to CAS 413, the measurement date is the expiration date for the last contract.
- In case the Board doesn’t amend CAS 413 to exclude benefit curtailments as a triggering event, the measurement date is the date all benefits for the segment stop accruing.

In the case of a plan termination, instead of defining the measurement date, we recommend defining the segment closing adjustment to either be the surplus assets that revert to the contractor after all plan liabilities are settled and asset reversion taxes are applied, or the actual amount needed to fully settle all plan liabilities.

CAS 413-50(c)(12)(iv) Plan Improvements

The following issues were posed in the FRN, with respect to phase-in of increases in liabilities associated with pension plan improvements adopted within 60 months of the date of the event which triggers a segment closing adjustment:

- benefit increases due to automatic increases in IRC 415 and 401(a)(17) limitations;
- “prudent” benefit improvements; and
- replacement defined benefit plan.

Benefit increases due to automatic increases in IRC 415 and 401(a)(17) limitations are not plan improvements (amendments) *adopted* within 60 months of the applicable event. Thus, these don’t fall under the plan improvements described in CAS 413-50(c)(12)(iv).

It is unclear what the Board means with regard to “prudent” benefit improvements, thus we have no opinion on this.

Assuming benefit curtailments will be excluded as a triggering event, a replacement defined benefit plan appears irrelevant in the case of a sale of a segment, discontinuance of operations or contract termination. With regard to a plan termination, it seems highly unlikely for a contractor to establish a replacement defined benefit plan after deciding to terminate an existing defined benefit plan. In other words, we believe a replacement defined benefit plan is irrelevant in the context of CAS 413-50(c)(12)(iv).

CAS 413-50(c)(12)(v) Sale or Transfer of Ownership

Upon a sale of a segment (or part of a segment), as pointed out in the FRN, the pension asset amount transferred could be different from the CAS assets for the segment. The asset transferred may be different because of the requirements under IRC 414(l), in the case of qualified defined benefit pension plans, or because of sale negotiations.

If the amount transferred is lower than the CAS assets for the sold segment, we believe that current provisions are sufficient in addressing the difference in asset values from both the seller and the buyer’s perspective:

- Buyer: CAS costs would be calculated based on the pension assets and liabilities the buyer received, following current CAS provisions.
- Seller: The amount retained by the seller would be subject to a segment closing adjustment as provided under current CAS 413-50(c)(12)(v).

If the transfer amount is greater than the CAS assets for the sold segment, current provisions are also sufficient for the buyer, but not necessarily for the seller:

- Buyer: The excess amount would be treated as a prepayment credit for the buyer.
- Seller: The prepayment credit remaining with the seller could be reduced by the same amount of excess assets transferred to the buyer.

The above approach will work for the seller only if the prepayment credit existing prior to the sale is sufficient to cover the excess assets for the buyer. If the existing prepayment credit is insufficient and the asset amount transferred to the buyer is due to the requirements of IRC 414(l), we believe the Board needs to address the conflict between CAS and this other government regulation.

One approach to consider is to allow *negative* prepayment credits on the seller side. Following is an illustration of this approach.

Assume Segment A is sold, the applicable CAS asset amount for the segment at the time of the sale is \$100 million, the IRC 414(l) transfer amount is \$120 million and the existing prepayment credit on the seller side prior to the event is \$5 million. Furthermore, assume \$500 million in total plan assets.

In millions	Before Transaction	Transaction	After Transaction
Seller			
CAS assets – Segment A	\$100	\$(100)	\$ 0
CAS assets – Other Segments	\$395	\$ 0	\$395
Prepayment Credit	<u>\$ 5</u>	<u>\$(20)</u>	<u>\$(15)</u>
Total	\$500	\$(120)	\$380
Buyer			
CAS assets – Segment A	\$ 0	\$100	\$100
CAS assets – Other Segments	\$ 0	\$ 0	\$ 0
Prepayment Credit	<u>\$ 0</u>	<u>\$ 20</u>	<u>\$ 20</u>
Total	\$ 0	\$120	\$120
Total			
CAS assets – Segment A	\$100	\$ 0	\$100
CAS assets – Other Segments	\$395	\$ 0	\$395
Prepayment Credit	<u>\$ 5</u>	<u>\$ 0</u>	<u>\$ 5</u>
Total	\$500	\$ 0	\$500

Because the prepayment credit at the time of the sale is only \$5 million, and not sufficient to cover the \$20 million difference between the amount required by IRC 414(l) and the CAS assets for the segment, the prepayment credit for the seller after the sale becomes negative \$15 million. For determining ongoing CAS costs for the seller after the sale, CAS assets will reflect the actual asset value (\$380 million in this example) increased by \$15 million.

A negative prepayment credit would differ from an unallowable cost, in that it would increase with actual trust returns. A contractor could eliminate a negative prepayment credit by making a contribution to the plan that would not be reimbursed by the government.

A related issue mentioned in the FRN is with regard to partial sale of segments. We believe that assets for the partial segment should be determined under CAS 413-50(c)(5)(ii) and liabilities determined under CAS 413-50(c)(12)(i). As long as there is an ongoing contract and the seller's plan is not terminated, in our opinion it will be less disruptive to the contracting process if the segment closing adjustment is not required for the seller for both (a) the part of the segment not involved in the sale, and (b) any asset and liabilities retained by the seller that is attributable to the part of the segment that is sold.

CAS 413-50(c)(12)(vi) Government's Share

This provision states the following:

“The Government's share of the adjustment amount determined for a segment shall be the product of the adjustment amount and a fraction. The adjustment amount shall be reduced for any excise tax imposed upon assets withdrawn from the funding agency of a qualified pension plan. The numerator of such fraction shall be the sum of the pension plan costs allocated to all contracts and subcontracts (including Foreign Military Sales) subject to this Standard during a period of years representative of the Government's participation in the pension plan. The denominator of such fraction shall be the total pension costs assigned to cost accounting periods during those same years. This amount shall represent an adjustment of contract prices or cost allowance as appropriate. The adjustment may be recognized by modifying a single contract, several but not all contracts, or all contracts, or by use of any other suitable technique.”

If the purpose of this provision is equity between the government and the contractor, we believe this provision is flawed. To illustrate the flaw, consider the following simplified example. Assume that a contractor has three Segments A, B and C, where A and B are government segments while C is a commercial segment. Assume that since plan inception, each of the segments has been assigned one third of the plan's costs. Now, assume that Segment A is closed and therefore a segment closing adjustment is required.

Amounts in Millions				
Segment	Assets	Liabilities	Surplus/ (Deficit)	Pension Costs Since Plan Inception
A (government)	\$300	\$200	\$100	\$150
B (government)	\$300	\$200	\$100	\$150
C (commercial)	\$300	\$200	\$100	\$150
Total Plan	\$900	\$600	\$300	\$450

According to CAS 413-50(c)(12)(vi), since \$300 million has been charged to government contracts (\$150 for Segment A and \$150 for Segment B), the government's share of the \$100 million surplus for Segment A will be:

$$100 \times 300 / 450 = \$66.6 \text{ million,}$$

i.e., 2/3rds of Segment A's surplus of \$100 million

In our opinion, if Segment A only did government work, the government's share should be the entire surplus for Segment A, i.e., \$100 million. Only if Segment A did both government and commercial work would it seem appropriate to apply a fraction to Segment A's surplus to determine the government's share. In this case, this fraction should reflect how much of this particular segment's pension costs were allocated to this segment's government contracts versus all of its contracts (as opposed to the contracts for all segments). A reasonable proxy may be revenues from the segment's government contracts as a percentage of the total revenues for the segment.

On this issue of determining the government's share of the segment closing adjustment, it is our understanding that government auditors impose the DCMA/DCAA joint guidance based on the government's interpretation of *Teledyne, Inc. v. United States*, 50 Fed. Cl. 155 (2001). It is our understanding that contractors find it difficult, if not impossible, to implement this guidance. Furthermore, while based on a court ruling, the fact remains that the guidance is outside of CAS.

Because of the foregoing, we believe that a very important outcome of this rulemaking should be to come up with a replacement to the current CAS 413-50(c)(12)(vi) that is both equitable and practical, and provides enough clarity so that lengthy disputes on the matter can be avoided. The revised provisions will need to address the following:

- a. Basis for determining the fraction – The current basis is pension costs. As mentioned above, we recommend allowing a reasonable proxy, e.g., revenues from the segment's government contracts as a percentage of the total revenues for the segment.
- b. Treatment of employee contributions – We believe it is appropriate that, if there are/have been employee contributions in the plan, the deficit or surplus attributable to the employee contributions should be determined and carved out of the total deficit or surplus for the segment, before the fraction for the government's share is applied.
- c. Period (representative) of the government's participation in pension costs – In practice, this period will likely be very difficult to define except for plans that have been in existence only for a few years. For practicality and to avoid lengthy disputes, we recommend that the Board specify a safe harbor number of years that would be considered acceptable.

CAS 413-50(c)(12)(vii) Recognition

Questions were posed in the FRN regarding recognition of the segment closing adjustment in future accounting periods through prepayment credits and unfunded accruals. To address these questions, consider the following example, where no government contracts remain for Segment A and it is subject to a segment closing adjustment (all amounts in millions):

Before

Liability for Segment A	\$ 300
CAS Assets	
• Segment A	\$ 400
• Segment B	\$ 300
• Segment C	\$ 200
• Total CAS Assets	\$ 900
Prepayment Credit	\$ 100
Total Market Value of Assets	\$1,000

After

Liability for Segment A	\$ 0
CAS Assets	
• Segment A	\$ 100 (segment closing adjustment amount – surplus)
• Segment B	\$ 300
• Segment C	\$ 200
• Total CAS assets	\$ 600
Prepayment Credit	\$ 100
Total Market Value of Assets	\$ 700

Note that \$300 million is used to settle Segment A's liabilities, thus the total assets reduce from \$1 billion to \$700 million. After settling Segment A's liabilities, a surplus of \$100 million attributable to Segment A remains. Because this is a surplus, it should benefit the government. However, adjusting the prepayment credit (or similarly, setting up an unfunded accrual) will not benefit the government. One approach to consider, that results in benefiting the government, is to allocate the \$100 million to the remaining Segments B and C. This allocation will result in lower future pension costs for these remaining segments. Similarly, in the case of a deficit, adjustment the prepayment credit does not benefit the contractor. The deficit will need to be allocated to the remaining segments, resulting in higher future pension costs (higher reimbursements) for the contractor.

While the above approach works in theory, practical issues need to be considered, such as the following:

- Because the approach impacts future pension costs of the remaining government segments, the impact on fixed price contracts will need to be addressed.
- Contractors will want to consider the impact of this approach on their future competitiveness.
- The method for allocating the surplus or deficit will need to be specified. For example, should the segments with higher pension costs get a greater allocation of a surplus? Should the remaining segments get equal dollar allocations?
- This approach will result in shifting government assets between segments. The Board will want to consider the practical implications of assets that the government builds up under "Program A" being shifted to reduce costs under "Program B."

Several other issues need to be clarified in recognizing the government's share of a segment closing deficit or surplus.

- In case of a deficit, must the government payment to the contractor for the deficit be deposited in the pension trust? In the case of a surplus, must the contractor payment to the government come from pension trust? Note that qualified plan assets cannot revert to the contractor unless the plan is terminated.
- Pending resolution of a segment closing adjustment, how should ongoing calculations be performed? For example, in the case of a pension deficit, how should the segment closing adjustment be reflected in ongoing cost calculations prior to the amount being deposited in the trust?

General Questions

Questions on removing the zero floor on ongoing costs (i.e., allowing pension cost refunds to the government on an ongoing basis) and increasing the current Assignable Cost Limitation (ACL) ceiling on costs were posed in the FRN.

Increasing the ACL will help with the volatility of ongoing costs. We have recommended and illustrated the advantages of a higher ACL in our comment letters to the Board during the rulemaking process for CAS Harmonization with PPA.

On the other hand, the removal of the zero floor would be problematic to implement considering that assets cannot be taken out of qualified pension plan trusts. Unless pension assets actually revert to the contractor, a floor of zero should be maintained for CAS costs.

Issues Not Noted in the Federal Register Notice*CAS 413-50(c)(1) Basis for Allocation of Costs to Segments*

For composite accounting, current CAS 413 states that the basis for allocating costs to segments should be representative of the factors on which the pension benefits are based. The examples given are payroll or counts of active participants. Since many plans have been frozen to new entrants, in time, there will be fewer and fewer active participants in many contractors' pension plans. The current basis won't work for inactive-only segments, and doesn't work well for segments with very few active participants.

To address this issue, one approach to consider is to completely redefine the basis for segment cost allocation under composite accounting to be the sum of the normal cost and the 10-year amortization of the unfunded actuarial liability, if any, for each segment. We believe that this, in fact, reflects factors on which the pension benefits are based since it recognizes both the normal cost and the actuarial liability for a segment. However, it is not an example explicitly described in current CAS 413-50(c)(i)

We recognize that this will entail relatively more effort compared to allocating by covered pension payroll or headcount. However, we believe it is the most equitable alternative and it is more in line with cost allocation under segment accounting. In fact, this is a simplified version of segment accounting where assets and amortization bases will not need to be tracked by segment on an ongoing basis.

This allocation method will require the following steps each year:

1. The composite pension cost for the entire plan will need to be determined as under current CAS provisions.
2. The segment to which a participant belongs will need to be known.
 - a. For active participants, this step is not new; this is already necessary under current CAS where the allocation basis is either covered active payroll or headcount.
 - b. For inactive participants, this step may be new. This will require each inactive participant to be assigned to a segment.
3. The normal cost and the actuarial liability for each segment will then need to be determined.
4. Assets by segment will then be determined, by allocating the total plan asset in proportion to segment liabilities. This means that all segments will have the same funded status every valuation date.
5. The sum of the normal cost and the 10-year amortization of any unfunded actuarial liability will then be determined for each segment. Note that this means a "fresh start" 10-year amortization base each year.
6. The CAS cost for each segment will then be determined by multiplying the composite pension cost for the plan by a fraction where
 - a. the numerator is that segment's normal cost plus 10-year amortization of the unfunded actuarial liability, and
 - b. the denominator is the sum of all segments' normal costs plus 10-year amortizations of the unfunded actuarial liabilities.

We recognize that Step 2b above could be a significant undertaking. The assignment of inactives to a segment could be done on a "last place worked" basis. In the case of inactive participants whose last place worked cannot be determined, the contractor will need to make an effort to assign such participants based on historical business mix. For example, if segment A was on average 60% of the business historically, it will be assigned inactive participants whose liability is about 60% of all inactive participants whose last place worked cannot be determined.

Inactive participants that would be otherwise assignable to segments that no longer exist can be assigned to a “homeless inactive segment,” and the costs for this segment treated as residual costs under CAS 403.

Other cost allocation issues that need clarification are as follows:

- It should be clarified whether ongoing calculations for a closed segment needs to be done separately from the rest of the plan. This implies that, if composite accounting is the allocation method used prior to the segment closing, going forward a hybrid of composite and segment accounting will be used. This change should not be considered a cost accounting method change.
- Ongoing costs for a closed segment remain as costs for doing business and treatment of such costs as residual costs under CAS 403 should be clarified, assuming the contractor still has contracts with the government to assign such costs.

CAS 413-50(c)(9) Inactive-Only Segments

Under segment accounting, this provision allows for formation of an inactive-only segment, along with active-only segments. When a participant becomes inactive, regardless of their employment history, they are transferred to the inactive-only segment.

The cost allocated to an active-only segment equals the CAS cost directly calculated for that segment plus an allocated portion of the CAS cost directly calculated for the inactive segment, using CAS 413-50(c)(i) as the basis for the allocation.

As the business mix changes over time, as some segments grow and other segments contract, as inactive participant counts grow and active participant counts dwindle because many pension plans have been closed to new entrants, the above approach will become more and more problematic. At the extreme, the last segment with active participants will bear all the costs for the pension plan.

We see two possible courses of action to address this issue:

1. Discontinue CAS 413-50(c)(9) going forward and define the process to undo the inactive-only segment. This will require re-assignment of the inactive participants to the otherwise active-only segments. The same considerations for Step 2b in the discussion of CAS 413-50(c)(1) above would apply.
2. Come up with a method for allocating costs of the inactive-only segment that is different from CAS 413-50(c)(1).

We recognize that these alternatives have their own challenges. As mentioned previously, assigning inactive participants to segments under the first alternative would be a significant undertaking at transition.

With regard to the second alternative, the biggest challenge would be to come up with a method that preserves as much as possible the causal relationship of where benefits are accrued and which segments will pay for the costs of those benefits.

Determining Segment Assets

There are several provisions in current CAS that define assets for groups of participants. For consistency, we recommend a review of the following CAS 413 provisions on asset values:

- CAS 413-50(c)(5)(ii) – when segment accounting is first established for one or more segments
- CAS 413-50(c)(8) – when assets and liabilities are transferred when participants transfer from one segment to another
- CAS 413-50(c)(9) – assets for inactive-only segments
- CAS 413-50(c)(12)(ii) – assets at segment closing

Settlement of Inactive Liabilities

We note that a number of the challenges mentioned above are due to the growth of inactive liabilities. For example, while CAS 413-50(c)(1) and (9) were fine for many years, they are becoming unworkable. Segment closing adjustments could be very significant and very contentious because of the build-up of inactive liabilities over the years.

As such, we highly recommend that the Board clarify the treatment of lump sum windows and annuity purchases. Guidance on this matter will facilitate contractors taking advantage of market opportunities to settle portions of their inactive liabilities over time. If inactive liabilities had been settled over the years when many pension plans were in surplus positions (instead of those surplus assets disappearing due to the volatility of the investment markets), the costs that the government will have to reimburse today and in future years would be much less. It will be very unfortunate if we don't learn from lessons of the past.

Finally, as discussed in the second public hearing, through this letter we are recommending (to the FAR Council Working Group) clarification of the intent of FAR 31.205(6)(j)(v), i.e., that it is intended for IRC Section 401(h) and 420 transfers, and not intended to prohibit annuity purchases.

In Closing

Again, we appreciate the opportunity to comment on these important regulations. We commend the Board for soliciting input through the FRN and through public hearings. Please direct any questions regarding our comments to Judy Ocaya at 949-253-5239 or judy.ocaya@towerswatson.com.

Sincerely,



Gene H. Wickes
Managing Director, Benefits Segment