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Submitted Electronically

Office of Federal Procurement Policy
Cost Accounting Standards Board
725 17th Street, NW
Room 9013
Washington, D.C. 20503
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Re: CAS-2007-02S

We appreciate the opportunity to offer a response to the questions raised in the Staff Discussion Paper regarding harmonization of CAS 412 and 413 with the Pension Protection Act of 2006. This is obviously an important project for both the government and the contracting community. Future changes to the CAS rules need to respect the Congressional mandate for harmonizing the CAS rules and the ERISA rules and to also try to reflect the theme of maintaining a position of equity between the government and industry.

Question 1. Should the Board apply any revisions to all cost-based contracts and other Federal awards that are subject to full CAS coverage, or only to ``eligible government contractors'' as defined in Section 106?

We believe that the appropriate approach would be to apply any revisions to all contractors, and not just to "eligible government contractors." Having two sets of CAS rules would create a system that is unnecessarily complicated. It would also contradict an underlying objective of having a level playing field for all government contractors that are covered by the CAS.

Question 2. Does the current CAS 412 and 413 substantially meet the Congressional intent of the PPA to protect retirement security, to strengthen funding and ensure PBGC solvency?

If the members of Congress believed that the current CAS 412 and 413 adequately satisfied their intent to protect retirement security then they probably would have exempted government contractors from the new funding rules. But instead they only granted a temporary deferral for a few years for the largest defense contractors in order to allow some time for the CAS Board to harmonize the CAS rules with the new funding rules.

The Congress did, however, recognize that the Federal Government has burdened government contractors with two sets of rules for determining pension cost, and the resulting cost calculations could be quite different under the different rules. This could cause some major challenges to contracting companies as they try to manage company cash flow, and could be disruptive to allowing those companies to operate efficiently. Congress recognized that it would not only reflect the best interests of the contracting companies, but also of their customers, to coordinate the pension cost rules and allow the companies to operate much more effectively.

So, there is really a dual intent on the part of Congress with regard to government contractors. There is the objective of improving retirement security, which applies to all companies that sponsor pension programs. But there is also the objective of allowing contractors to operate in an environment that does not cause business concerns due to pension cash flow disparities. It is this second purpose that motivated the harmonization provision in the PPA.

Question 3. Should CAS harmonization be focused only on the relationship of the PPA minimum required contribution and the contract cost determined in accordance with CAS 412 and 413?

Harmonization should focus on the relationship of the PPA minimum required contribution and the contract cost under CAS. This is the basic requirement under the PPA and is the crux of the harmonization issue.

(a) Do the measurement and assignment provisions of the current CAS 412 and 413 result in a contractor incurring a penalty under ERISA in order to receive full reimbursement of CAS computed pension costs under Government contracts?

When CAS 412 was first adopted the pension cost was closely aligned with ERISA. Over time the ERISA funding requirements have changed and the CAS has not made likewise changes to its pension cost calculations.

For the most part it seems as though the ERISA funding requirements have generally been higher than the CAS pension cost. This has resulted in the creation of CAS prepayment credits. These prepayments represent allowable cost that has been properly funded by the contractor, but which has not yet been reimbursed by the government. This difference between the ERISA minimum funding requirement and the CAS assignable cost does create cash flow issues for the contractor. This could be viewed as a type of "penalty", but is not specifically a "penalty under ERISA". The passage of the PPA will likely exacerbate the cash flow issues.

(b) To what extent, if any, should the Board revise CAS 412 and 413 to harmonize with the contribution range defined by the minimum required contribution and the tax-deductible maximum contribution?

Section 106 of the PPA requires the Board to revise CAS 412 and 413 to harmonize with the minimum required contribution under PPA. It would probably also make sense to follow the theme of the current CAS and to limit the assignable cost in any year to the maximum tax deductible amount plus any prepayment credits. The PPA has dramatically increased the tax deductible limit under ERISA. So maintaining this limitation might not actually have much of an impact on the CAS assignable cost. Therefore it should not be a cause for concern to retain this limitation.

(c) To what extent, if any, should ERISA credit balances (carryover and prefunding balances) be considered in revising CAS 412 and 413?

Application of the ERISA funding standard account balance in the CAS cost calculations would probably only work if we were at a point in time where we were initially adopting both ERISA and CAS, and the ERISA and CAS calculations were exactly the same. Because we already have some history with both CAS and ERISA, and there may continue to be some differences in the cost calculations in the future, it would not make sense for the CAS assignable cost calculation to reflect ERISA credit balances in some way.

However, the current prepayment credits under CAS represent previously funded cost that has not been reimbursed to the contractor. It would only be logical and equitable to retain the concept of prepayment credits that currently resides in CAS 412 and 413.

(d) To what extent, if any, should revisions to CAS be based on the measurement and assignment methods of the PPA?

In order to truly comply with the harmonization requirement the measurement and assignment methods of the PPA should provide the foundation for the revisions to CAS. Having differences in the measurement and assignment methods will just make it very difficult to try to get the two sets of rules to be synchronized with each other.

(i) To what extent, if any, should the Board revise the CAS based on rules established to implement tax policy?

We are not really sure just what the focus of this question is. Some changes that have historically been made to ERISA have been driven by tax policy and some changes have resulted from pension plan solvency concerns. The funding changes under PPA seem to have been motivated by solvency concerns. Irrespective of the motivation for the evolvement of ERISA we now have legislation that requires the CAS to harmonize with the funding requirements of ERISA. It seems that the Board should revise the CAS based on that requirement.

(ii) To what extent, if any, should the Board consider concerns with the solvency of either the pension plan, or the PBGC?

Similar to question 3(d)(i) above, we are not really sure we understand the crux of this question. If revisions to the CAS should happen to enhance the solvency of pension plans or the PBGC then that would probably be a positive outcome. But the Board should not specifically focus on those issues. Instead, the Board should just try to reach harmony with the ERISA funding requirements.

Question 4. (a) Accounting Basis. For Government contract costing purposes, should the Board (i) Retain the current ``going concern'' basis for the measurement and assignment of the contract cost for the period, or (ii) revise CAS 412 and 413 to measure and assign the period cost on the liquidation or settlement cost basis of accounting?

In responding to this question we need to first revisit the concept of the "going concern" basis vs. the liquidation basis for the measurement of cost. The calculation of pension cost has been a dynamic and changing area of practice. Since their inception the measurements of pension cost for financial reporting under GAAP and for cash funding under ERISA have changed. The concepts that are now in place for those purposes are considered to provide the appropriate cost measurements on a "going concern" basis by the regulatory and professional associations that oversee those functions. The CAS has continued to follow an older, traditional approach for cost measurement. There is now an opportunity for the CAS to be realigned with the cost measurement concepts that have been adopted by the financial accounting community and by the ERISA regulatory bodies. In fact, the Congress has provided a mandate for that to occur.

(b) Actuarial Assumptions. For contract cost measurement, should the Board (i) Continue to utilize the current CAS requirements which incorporate the contractor's long-term best estimates of anticipated experience under the plan, or (ii) revise the CAS to include the PPA minimum required contribution criteria, which include interest rates based on current corporate bond yields, no recognition of future period salary growth, and use of a mortality table determined by the Secretary of the Treasury?

In order to maintain consistency with the other aspects of the pension funding requirements and to fulfill the requirement for harmonization with the PPA the CAS should be revised to incorporate the actuarial assumptions that would apply under PPA.

(c) Specific Assumptions. Please comment on the following specific assumptions:

(i) Interest Rate: (1) For measuring the pension obligation, what basis for setting interest rate assumptions would best achieve uniformity and/or the matching of costs to benefits earned over the working career of plan participants? (2) To what extent, if any, should the interest rate assumption reflect the contractor's investment policy, and the investment mix of the pension fund?

The best approach would be to adopt the PPA interest rate for the CAS cost calculations.

(ii) Salary Increases: For measuring the pension obligation, should the CAS exclude, permit or require recognition of future period salary increases?

We believe that the CAS should follow the PPA. Salary increases would only apply for the one-year cost measurement period.

(iii) Mortality: For measuring the pension obligation, should the CAS exclude, permit, or require use of a (1) Standardized mortality table, (2) company-specific mortality table, or (3) mortality table that reflects plan-specific or segment-specific experience?

CAS should allow the use of any mortality table that is acceptable under PPA.

(d) Period Assignment (Amortization). For contract cost measurement, should the Board (i) Retain the current amortization provisions allowing amortization over 10 to 30 years (15 years for experience gains and losses), (ii) expand the range to 7 to 30 years for all sources including experience gains and losses, (iii) adopt a fixed 7 year period consistent with the PPA minimum required contribution computation, or (iv) adopt some other amortization provision?

The Board should adopt a fixed 7 year period consistent with the PPA minimum required contribution.

(e) Asset Valuation.

(i) For contract cost measurement, should the Board restrict the corridor of acceptable actuarial asset values to the range specified in the PPA (90% to 110% of the market value)?

The asset corridor should be restricted to the range specified in the PPA.

(ii) For contract cost measurement, should the Board adopt the PPA's two year averaging period for asset smoothing?

The Board should also adopt the PPA's two year averaging period for asset smoothing.

Adopting the assumption and amortization requirements found in PPA should greatly enhance uniformity among contractors. This would be consistent with the theme of having a level playing field for government contractors and would also be consistent with the goal of harmonization.

There are, however, some differences between ERISA and CAS that will probably need to remain. For example, question 3(c) already mentioned the funding standard account credit balance and the CAS prepayment credits. Each of these concepts is specific to either ERISA or CAS and should be retained by their respective governing rules.

Question 5. To what extent, if any, should the Board revise the CAS to include special funding rules for ``at risk'' plans?

We believe that harmonization should include recognition of the PPA funding requirements for "at-risk" plans. The determination of whether or not a plan is "at-risk" should be based on the PPA requirements. In other words there should not be some type of special criteria under CAS in order to determine if a plan is "at-risk".

Question 6. (a) To what extent, if any, should the measurement and assignment provisions of CAS 412 and 413 be revised to address contractor cash flow issues?

We understand that the driving force behind the harmonization requirement was the need to address contractor cash flow issues. The federal government has promulgated two different sets of rules for government contractors for determining pension cost. These two sets of rules have diverged over time and yield different cost results, which has created the cash flow issues.

The Congress has recognized that there are several concerns caused by this situation. First, government contractors are required to provide a certain level of cash funding for pension costs, but often times are restricted from assigning some of that cost to contracts. The assignment of cost might be deferred for several years, or it can be deferred for many years into the future. Government contractors do not have the ability to increase prices to more quickly recoup this cash expense. As these unrecovered costs continue to grow it hinders the ability of those companies to properly manage their cash flow and to operate most effectively and efficiently. Not only is this an unfair consequence for government contractors, but it is also clearly in the best interests of both the contracting companies and their customers to not burden those companies with conflicting rules that create hurdles to efficient operations.

Second, one of the desires of the Congress was to improve the health of the private pension system and protect the interests of pension participants. If cash flow issues for government contractors are exacerbated by the PPA then that may eventually cause some of those companies to give consideration to exiting the private pension system.

Third, if some government contractors do decide to exit the private pension system, because of the way in which the contracting rules are structured they would probably distribute assets and purchase annuities for the participants. This would likely result in a fairly sizeable cost claim against the government.

For these reasons the Congress has concluded that the appropriate remedy would be to harmonize the pension cost rules that are promulgated by the government.

(b) To what extent, if any, do the current prepayment provisions mitigate contractor cash flow concerns?

The prepayment provisions do permit allowable cost that has not been assigned to eventually be recovered, at least in theory. As the prepayment credits continue to grow, and as the timing for eventual cost recovery continues to be deferred into the future, the prepayment credits do not provide adequate relief from the cash flow issues.

(c) To what extent, if any, should the prepayment credit provision be revised to address the issue of potential negative cash flow?

It is not really the prepayment provisions that need revision. Instead it is the calculations that result in the creation of prepayment credits that need to be addressed.

Question 7. (a) (i) To what extent, if any, would adoption of some or all of the PPA provisions impact the volatility of cost projections?

Adopting the basic provisions of the PPA is likely to increase the volatility of cost from year to year. But the source of cost and cash flow mismatch is not the volatility of costs. Instead it is the variance between forecasted costs and actual costs that causes the problem. If costs were volatile but predictable then this would not be an issue. Of course, the potential volatility introduced by adopting the PPA provisions would make it more difficult to accurately forecast costs.

(ii) Are there ways to mitigate this impact? Please explain.

Differences between forecasted and actual costs (both positive and negative) should be identified and applied as an adjustment to future contract prices. This could be accomplished by amortizing this difference over a reasonable period of time. The amortization could begin in the year following the year for which the difference arose, or the start of the amortization period could be delayed for a year.

We believe that pension cost should not cause a financial advantage for the contractor, nor should it result in an advantage for the government. Valid cost that is funded into a trust should be reimbursed by the government and should not result in an unexpected cost that is borne by the contractor. Similarly, the government should not have to pay for previously anticipated cost that does not materialize. Contractor profits should be based on program performance and should not be skewed by pension cost reimbursements that are either too small or too large. There may not be a perfect solution to eliminate this issue regarding pension cost variance, but we should try to develop a mechanism for minimizing the potential impact.

Modeling could be done to provide a more detailed recommendation regarding this amortization concept. But this should be undertaken only after the range of potential changes to the CAS has been narrowed and there is more guidance regarding the likely direction for those changes.

Another issue that could receive special consideration is the transition to a revised CAS. At the time any changes to CAS are adopted, there will be a resulting variance between previously forecasted cost that has been included in pricing and the assignable cost that is calculated under a revised CAS. Similar to the mechanism outlined above, the amount of that transitional difference could be captured and reflected as an adjustment to future years' assignable costs through some type of transitional amortization.

(b) To what extent, if any, should the CAS assignable cost limitation be revised as part of the efforts to harmonize the CAS with the PPA?

The assignable cost limit could be retained without change (other than reflecting the changes to the CAS calculations outlined in the responses above).

(c) To what extent, if any, should the CAS be revised to address negative pension costs in the context of cost volatility?

The negative cost concept would only be appropriate if the companies that sponsor pension plans could remove assets from the trust funds in order to pay those assets to the government. Since companies are not permitted to do that the negative cost concept would be impractical.

Also, ERISA does not recognize negative costs. The ERISA minimum contribution has a floor of zero. So having negative pension costs would not be consistent with the requirement to harmonize the CAS with the minimum contribution under the PPA.

Question 8. (a) To what extent, if any, would adoption of some or all of the PPA provisions affect the measurement of a segment closing adjustment in accordance with CAS 413.50(c)(12)?

If there is an event that triggers a segment closing that includes the distribution of plan assets to the plan participants then the measurement of the segment closing liability should be the cost of annuity purchases and lump sum payments. If the segment closing event does not include distribution of the plan assets then the liability measurement should be based on the assumptions and methods outlined in the PPA.

(b) To what extent, if any, should the CAS 413 criteria for a curtailment of benefits be modified to address the PPA mandatory cessation of benefit accruals for an ``at risk'' plan?

If CAS should adopt the PPA requirement for cessation of benefit accruals for an "at-risk" plan then that would trigger a segment closing event under CAS. If the "at-risk" status of that plan should eventually change then the plan could once again provide for continuing benefit accruals. It clearly would not be appropriate to apply the segment closing provisions under CAS to such a plan.

In fact, we believe that, in general, a benefit curtailment should not be considered as a segment closing. Ongoing cost measurements should continue to apply for pension plans that have experienced a benefit curtailment. Even the GAAP accounting rules distinguish between events that cause a curtailment and events that cause a settlement. The GAAP accounting treatment for each of these types of events is different, but the current CAS does not make such a distinction. We believe that if the company continues to have a meaningful contracting relationship with the government, and the pension plan is not terminated (with a resulting

distribution of assets), then the curtailed pension plan should continue to calculate assignable cost each year.

Question 9. (a) Prepayment Credits. Should prepayment credits be adjusted based on the CAS valuation rate or the PPA requirement to use the pension fund's actual ``return on plan assets'' for the period?

In keeping with the theme of harmonization with the PPA we believe that the prepayment credits should be adjusted based on the actual return on plan assets.

(b) Contributions Made After End of Plan Year. Should the interest adjustment for contributions made after the end of the plan year be computed as if the deposit was made on the last day of the plan year or on the actual deposit as now required by the PPA?

Again, in keeping with the theme of harmonization with the PPA, we believe that the interest adjustment for contributions made after the end of the plan year should be computed as of the actual deposit date.

(c) Collectively Bargained Benefits.

(i) To what extent, if any, should the CAS be revised to address the PPA provision that allows the recognition of established patterns of collectively bargained benefits?

We believe that the CAS should align with the PPA and allow for the recognition of established patterns of collectively bargained benefits.

(ii) Are there criteria that should be considered in determining what constitutes an established pattern of such changes?

The criteria for determining an established pattern of collectively bargained benefits should follow the provisions of PPA.

Question 10. The Board would be very interested in obtaining the results of any studies or surveys that examine the pension cost determined in accordance with the CAS and the PPA minimum required contributions and maximum tax-deductible contribution.

We agree that it would be very helpful and productive for the Board to receive cost projections regarding the potential impact of proposed changes to the CAS. As we have already mentioned, before industry undertakes such an exercise it would be very helpful to narrow the range of potential changes to the CAS. That would allow the modeling efforts to focus on the most pertinent issues and to be completed in a more time-efficient manner. Our modeling could include examples of how the amortization for variances between forecasted and actual costs and the transition amortization concepts could be applied (see response to question 7(a)).

Question 11. In light of the changes to the PPA, should the Board consider including specific requirements in CAS 412 and 413 regarding the records required to support the contractor's proposed and/or claimed pension cost?

Currently claimed pension cost is audited by the government and the contractor needs to provide appropriate support for the amount of the cost. If the Board feels that this is an area of concern that needs to be addressed then that is a separate issue from the harmonization with PPA. The task of harmonizing with the PPA should not create the need to revise any requirements for supporting claimed pension cost.

Thank you for your consideration of our responses. If you should need any additional information or clarification please contact me at 301-214-3906 or via my e-mail elliott.m.friedman@lmco.com.

Sincerely,

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