GENERAL DYNAMICS

EMAIL AND VIA OVERNIGHT MAIL

August 30, 2007

Cost Accounting Standards Board
Office of Federal Procurement Policy
725 17th Street, NW
Room 9013
Washington, DC 20503

ATTN: Laura Auletta

Re: CAS-2007-02S

We are pleased to provide your office with General Dynamics Corporation's (GDC) response to the Staff Discussion Paper (SDP), "Harmonization of Cost Accounting Standards (CAS) 412 and 413 with the Pension Protection Act of 2006 (PPA)," issued by the Cost Accounting Standards Board (CASB), Office of Federal Procurement Policy (OFPP), OMB.

For the reasons enumerated in our attached submission, GDC believes that Congress mandated that CASB change the CAS pension funding rules to reflect the new pension funding regime in the PPA. We believe that the law clearly articulates Congress' intent to require a harmonization of CAS 412 and 413 with the PPA.

For a number of reasons, Congress found the prior ERISA pension funding regime (upon which the current CAS rules are built) to be inadequate in achieving the public policy objective of securing appropriate pension plan funding. As a result, Congress chose to completely eliminate the prior ERISA rules in favor of a different funding regime. Thus, the foundation for the current CAS pension funding rules no longer exists and these rules should be changed. In enacting PPA, Congress clearly understood that the PPA changes would create a "disconnect" with the provisions of CAS 412 and 413. Congress evidenced this knowledge by mandating that CASB (as a recognized governmental body) "harmonize" the CAS pension funding rules with and into the pension funding scheme Congress laid out in PPA. In requiring "harmonization," we believe Congress is expecting CASB to develop a new set of CAS pension funding rules that materially reflect and respect the tenor of Congress' PPA changes and that deviate from Congress' PPA mandated pension funding regime only when necessary to address unique aspects of government contracting. Additionally, the legislation requires CAS to complete it changes by the end of 2009. We believe the PPA legislation requires CASB to change the current rules. We do not believe that Congress provided CASB the latitude to ignore the provisions of PPA or to find that its current CAS rules remain consistent with the wholesale changes made in the PPA.

We applaud CASB's willingness to begin examining these issues and encourage CASB to expedite these revisions. We will provide any input CASB would find helpful in completing its work. Finally, we respectfully request that CASB make it clear that the changes made to pension funding rules are to be treated as a "required change" under the applicable CAS rules.

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We hope our responses to the Staff Discussion Paper will help the Board understand and appreciate our concerns. We are committed to working together during the next stages of the rulemaking process. We appreciate the opportunity to provide our views on these important issues.

Sincerely,

General Dynamics Corporation

Henry C. Eickelberg
Vice President
Human Capital Processes

Scott E. Zamer
Director
Government Accounting and Internal Controls

Encl.

Submitted by
General Dynamics Corporation

In response to CAS-2007-02S

Harmonization of Cost Accounting Standards (CAS) 412 and 413 with the Pension Protection Act of 2006 (PPA)

30 August 2007

Background

In August 2006, President Bush signed the Pension Protection Act of 2006 (PPA) into law. Assuming continuation of the current low interest rate environment, PPA will require sharply increased cash contributions to defined benefit plans. This increased funding is driven by two changes PPA instituted:

1. Mandated use of lower interest rate assumptions and shorter amortization periods than were required prior to PPA; and
2. A substantial increase in a defined benefit plan's funding target. The funding target under prior law was 90% of liabilities. PPA requires plan assets equal to at least 100% of liabilities.

In reviewing the changes PPA has mandated, the Defense Contract Audit Agency (DCAA) recognizes that PPA's pension changes (i.e., the requirement to contribution significantly higher amounts of cash to contractor pensions) will NOT be immediately recoverable as an allowable cost because the current Cost Accounting Standards (CAS) provisions rules do not follow the lower interest rate assumptions and shorter amortization periods that are now required under federal law. *See* Audit Guidance on the Impact of the Pension Protection Act of 2006 (May 1, 2007). PPA imposes aggressive pension plan funding that will result in a significantly higher cash-flow outlay than what will be recognized and recoverable under the current CAS provisions. Initial industry estimates put this difference in the range of several billion dollars**.**

In changing federal law, Congress specifically acknowledged that there was a "disconnect" between the previous pension funding rules and those currently in effect under CAS. Considering this fact, Congress specifically directed Cost Accounting Standards Board (CASB) to end this difference by requiring CASB change its own rules to bring them into harmony with the requirements of PPA.

Clearly, CASB has no authority to change federal pension law. The provisions of PPA are the law of the land as it concerns defined benefit plan funding. In enacting PPA, Congress directed CASB to change its rules in a very specific manner. Congress directed CASB to change the current CAS rules so that they work in "harmony" with the provisions of PPA. Congress gave CASB four years to accomplish this requirement.

Congress's Specific Direction to CASB

Congress placed very clear requirements on CASB. First, Congress specifically added Section 106(d) of the PPA which requires the CASB (as a specifically stated entity) to "harmonize" the CAS with the provisions of PPA no later than 2010:

> (d) COST ACCOUNTING STANDARDS PENSION HARMONIZATION RULE.—The Cost Accounting Standards Board **<u>shall review and revise sections 412 and 413</u>** of the Cost Accounting Standards (48 CFR 9904.412 and 9904.413) to harmonize the minimum required contribution under the Employee Retirement Income Security Act of 1974 of eligible government contractor plans and government reimbursable pension plan costs not later than January 1, 2010. Any final rule adopted by the Cost Accounting Standards Board shall be deemed the Cost Accounting Standards Pension Harmonization Rule. [Emphasis added.]

Second, a few very large defense contractors (referred to in PPA as "eligible government contractors") are exempt from PPA until 2011 (or until CAS is "harmonize[d]" if that happens sooner). In providing for a deferred application of PPA, Congress clearly addressed the cash flow challenges that would be imposed on the government contractor community under PPA and avoid the hardship created by this possibility by deferring the application of PPA's requirements on eligible government contractors. In addition, deferring the application of PPA provided time to consider the application of the Antideficiency Act to these

significant additional costs. All other defense contractors subject to the CAS are required to comply with the increased pension funding mandates of the PPA beginning in 2008, even though the CAS will almost certainly not be "harmonize[d]" with the PPA until some future date.

Overarching Principles in Addressing CAS Pension Funding Changes

It is our understanding that this Staff Discussion Paper (SDP) and the responses it elicits represent the first step in the four step process required by the OFPP Act prior to the establishment of a new Cost Accounting Standard; the first step being to "consult with interested persons concerning the advantages, disadvantages and improvements anticipated in the pricing and administration of Government contracts as a result of the adoption of a proposed Standard."

Reiterating the summary provided in Section D.III. of the SDP, the CASB stated in 1992 that the primary purpose of the CAS is to "achieve: (1) An increased degree of uniformity in cost accounting practices among Government contractors in like circumstances, and (2) consistency in cost accounting practices in like circumstances by individual Government contractors over periods of time." Our responses to the questions posed by the SDP rely heavily on the presumption that the principles CASB enunciated in 1992 remain appropriate considerations in revisions to the CAS in order to achieve harmonization with the PPA. We believe that they do.

We have also presumed that the philosophy suggested in the preambles to the 1995 revisions to the CAS – namely that "this final rule has not adopted ERISA as an accounting method, but has modified accrual accounting to fit within the confines of practicable funding" – remains intact.

As an "eligible government contractor," we are very cognizant of the fact that an increase assignable and allocable funding costs may come with additional budgetary requirements. However, we do not believe that this issue should interfere with a contractor's ability to fully and timely recover assignable and allowable costs that Congress has otherwise mandated under federal law.

We would encourage CASB to expedite its rulemaking process so as to minimize the uncertainty that currently exists. And, in adopting final changes, CASB should specifically state that the changes in pension funding are "required changes" under the provisions of CAS.

We respectfully set forth below our responses to the eleven specific questions identified in the SDP.

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?

Any revisions the Board makes should apply equally to all contractors. We believe this for a number of reasons:

- **Two sets of rules would be burdensome**. We do not believe that the size of the contractor is an intended differentiator such that two different sets of pension funding rules is required. Additionally, establishing two sets of rules would be in conflict with the stated CASB objective of providing "an increased degree of uniformity in cost accounting practices among Government contractors in like circumstances."

- **Different Rules would add uncertainty in the Forward Pricing Process**. Due to fluctuating sales, some contractors could move in and out of the eligible government contractor status. This would make it difficult for them to accurately price out longer-term contracts. They legitimately would not know which status to assume they would be in when forward pricing their pension costs. DCAA would not have an adequate way to audit this assumption. In addition, any movement towards two separate set of funding rules would be in conflict with the CASB's stated objective of "consistency in cost accounting practices in like circumstances by individual Government contractors over periods of time."

- **Congress did not limit Harmonization to contractor size.** PPA Section 106 requires CASB to harmonize CAS pension funding rules in general, not just for eligible government contractors. Accordingly, it is clear that Congress intends CASB to provide a harmonized set of pension funding rules to apply to all government contractors regardless of size.

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?

No. PPA provides for an entirely different scheme for defined benefit pension funding. In enacting PPA, Congress clearly stated it was required to make the changes it made in PPA because the previous pension funding rules were inadequate in protecting retirement security, strengthening pension funding or ensuring PBGC solvency. Thus, the current CAS 412 and 413 rules are based on a pension funding scheme that Congress found necessary to entirely sweep away.

Clearly the purpose of the PPA was to accelerate pension funding with a targeted minimum level of assets that (at a minimum) equals the value of accrued benefits determined using approximate market assumptions. In contrast, the funding target under current CAS 412 and 413 is determined on an entirely different basis. Most notably, under CAS 412 and 413, the interest rate assumption is generally required to be reflective of expected long term returns on the plan's invested assets while under the PPA the interest rate assumption is reflective of the market yields of investment quality corporate bonds of appropriate duration. The only exception to this is under CAS 413-50(c)(12)(i) in the case of plan termination where all plan obligations are settled or assumed by the Pension Benefit Guarantee Corporation. In this limited case, liabilities are marked-to-market when determining the assignability of costs. However, note that even in this limited and infrequent situation, the assignability of costs does not infer that such costs are readily allocable or reimbursable as that is still dependent on the added requirements of FAR. While recognizing that the Board's mandate only concerns the assignment of pension costs, failure to assign them in a manner which facilitates a realistic expectation of reimbursement is tantamount to treating them as unassignable.

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?

While the law only instructs the Board to revise CAS 412 and 413 to harmonize with the ERISA minimum funding requirements, we believe that harmonization must also take into consideration the changes that the PPA has made to the maximum deductible limits.

GDC is sensitive to the potential length and complexity of the CAS rulemaking process and wholeheartedly appreciates the Board's desire to restrict this exercise to harmonization of the CAS with the PPA minimum required contribution. However, some provisions of PPA also address the maximum deductible limits. Reflecting these changes in the harmonization process would be consistent with the approach taken when the CAS were first formulated. At that time, the Board established rules that took into account the range of contributions permissible under ERISA and the Internal Revenue Code. Since that time, the minimums and maximums have been revised numerous times, but other than the 1995 amendments, the CAS rules have not been updated. Today, contractors often find that statutory contribution requirements are not within the ranges of assignable costs permitted under CAS. Without taking into account the maximum deductible limits in the harmonization process the likelihood of the inconsistencies increase. Accordingly, failure to address more than the PPA minimum required contributions is likely to result in a flawed result.

(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?

In the strictest sense, the only penalties that we are aware of that might conflict with current CAS 412 and 413 costs are situations in which contributions in excess of the maximum deductible amount are subject to excise taxes. The current CAS rules permit contractors to defer such contributions and treat them as cost deficits to be assignable in future accounting periods. Any revisions to the CAS rules should retain such provisions. However, under current CAS rules, contractors can be faced with situations in which the minimum contributions are in excess of the assignable costs which result in delayed, and perhaps uncertain, assignability. These situations are likely to become more frequent if harmonization is either delayed or implemented in a less than truly harmonized manner. In these situations contractors are faced with a financing penalty in that the contractors must use their own cash resources to fund the contributions with the risk that such funding will not be reimbursed. While under current CAS rules such contributions are treated as prepayment credits and are accumulated with interest, differences in the measurement of costs under the PPA rules and the current CAS rules could mean their assignability, and hence their recovery, may be delayed indefinitely. This would create uncertainty and increased risk for contractors.

(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?

At a minimum, we believe that harmonization requires the CAS 412 and 413 rules to permit the assignment of costs determined using the assumptions and methodologies defined in the PPA for minimum funding purposes. However, we believe that proper harmonization should also take into consideration the maximum deductible amounts as revised by the PPA since such maximums are explicitly coordinated with the approach used for determining the minimum required contributions.

Furthermore, we would strongly encourage the Board to harmonize CAS 412 and 413 to not only allow for the assignment of the minimum required contribution (adjusted for costs unallowable under the FAR) in the current cost accounting period but also include a transition adjustment that permits the rapid

assignment of prepayment credits that may have developed from the failure of the CAS and the PPA to be harmonized when PPA first became applicable for a contractor.

Finally, we would like to reiterate our position that any accounting changes contractors are required to make in response to the Cost Accounting Standards Pension Harmonization Rules should be treated as a "required change" to the contractor's established cost accounting practices subject to a request for equitable adjustment under CAS 9903.201-6(a), irrespective of whether such change is permissive or required under the harmonization rules. We believe that not doing so would be inconsistent with Congress' mandate that the CAS rules be harmonized with the provisions of PPA. In addition, while we recognize that FAR permits equitable adjustments only to be applied prospectively from the date of applicability to a contract, we ask the Board to consider approaches under which increased costs attributable to the PPA could be assigned to open contracts in the cost accounting period in which the increased costs are initially incurred. GDC as well as other 'eligible contractors' are already pricing fixed-price and flexibly-priced contracts for various programs with cost being incurred in 2011 and beyond. All other contractors will start being impacted in 2008. Defense contractors are not currently able to price any PPA impacts due to interpretative guidance issued by the Office of the Director, Defense Procurement and Acquisition Policy on December 22, 2006, and again by the Defense Contract Audit Agency in May 2007. Pursuant to that guidance, DoD contracting officers are requiring that contractors determine pension costs under the CAS as currently written, and are refusing both: (a) to negotiate any increase in contract prices or forward pricing rates related to the CAS changes required by the PPA, and (b) to include re-opener clauses to address such costs. DoD contracting officers are taking this position even in negotiating forward pricing rates for 2010 and later years, after the CAS is required to be amended. This leaves contractors in the untenable position of recognizing that pension costs are likely to increase but unable to address all those costs in contracts.

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

ERISA credit balances arise due to funding in excess of ERISA minimum contributions. The CAS counterpart is prepayment credits. Unless harmonization results in assignable costs that are at least equal to or greater than the PPA minimum funding requirements, ERISA credit balances should not be considered in revising 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?

We urge the Board to embrace measurement and assignment methods consistent with those required under the PPA in the harmonization process. Two of the considerations in the Board's 1992 Statement of Objectives, Policies, and Concepts were the elements of verifiability and the costs of implementation compared to the probable benefits of such Standards. Continuation of the current rules or the adoption of rules that deviate significantly from the measurement and assignment methods under PPA would require contractors to maintain a separate set of accounting and valuation procedures subject to entirely separate reporting and disclosure and that would undoubtedly require reconciliation in some manner between the two competing approaches in order to verify the correctness of the costs.

GDC understands that it may be feasible for harmonization to utilize approaches which do not measure costs in a manner consistent with those required by the PPA and hopes that the Board rejects such approaches. For example, one harmonization approach might provide that differences between the assignable cost and the PPA required contribution be assignable on an amortized basis instead of treated as a prepayment credit. However, we believe that the cost of such an approach would not justify any benefit that it is perceived to provide as it would perpetuate a basis for assignment that has increasingly become archaic in the accounting, regulatory and financial world.

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

GDC believes that the Board should continue to espouse an approach which modifies "accrual accounting to fit within the confines of practicable funding" as stated in the preambles to the 1995 revisions to the CAS. Failure to do so might result in situations in which either contributions are required by ERISA that are not systematically assignable or contributions are required to be made under CAS to be assignable but are not deductible. This latter situation, though not likely in the current interest rate environment, could arise if the economic climate reverts back to that of the 1980's when market interest rates were frequently greater than the expected long term returns on assets. It could also arise in a segment accounting context when one segment is underfunded while the plan as a whole is overfunded. Retention of the current treatment of allowable cost deficits would appear to address this situation.

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

The PPA was enacted to help ensure the solvency of pension plans and the PBGC. Adopting harmonization rules that ensure the assignability of minimum required contributions under the PPA should be sufficient to support the intent of the PPA to bolster the security of pension plans. However, failure by the Board to ensure such assignability would undermine the intent of Congress in enacting the PPA.

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?

GDC believes that CAS 412 and 413 must be revised to reflect the measurement of costs in a manner similar to that utilized by the PPA if it is desired to measure costs on a going concern basis. The measurement of pension costs in accordance with the PPA is largely consistent with current, and emerging, domestic and international financial accounting, as evidenced by US financial accounting standards and International Accounting Standards for measuring pension costs of employers on a going concern basis. Like the PPA, these standards dictate that pension costs be measured reflecting the yields of high quality debt instruments of appropriate duration. However, the PPA falls short of going concern accounting in that it fails to take into account future salary escalation in the determination of the cost of benefits accruing in the current period. In order to correct for this deficiency, the Board should consider permitting, or even continue to require, the recognition of future salary increases when measuring the cost of benefits provided under salary related plans.

(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?

GDC generally believes that the Board should revise the CAS to include assumptions consistent with the PPA. Note that critical to this revision is to use interest rates based on current corporate bond yields. We recognize that these interest rates may not reflect the anticipated experience of the invested assets. However, they do reflect a reasonable market estimate of rates available to settle the liabilities and, being market rates, represent the best estimate of where such rates will be in the future. To harmonize with the

PPA, the CAS only should take into account the likelihood that the invested assets may produce a different return as such experience actually develops. However, since this will impact costs in future accounting periods and not the current accounting period, it would seem more appropriate to be reflected with respect to forward pricing projections which currently are addressed under the FAR and not the CAS.

(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?

For financial accounting which is intended to match costs to benefits, this approach is utilized as the best estimate of the cost of benefits for defined benefit pension plans. While it is understandable to be concerned with the fluctuations in costs that may occur with the fluctuation in the interest rate environment, it should be recognized that interest rate fluctuations have an impact on other cost elements that may affect contract pricing. For example, while a lower interest rate environment may produce higher pension costs in the current period; higher interest rates are typically reflective of an inflationary environment under which the contracts costs are often greater. The net effect of this negative correlation is that overall costs are likely to be more stable and predictable than the component pieces.

(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?

GDC believes that the best approach to harmonization would not reflect the contractor's investment policy in the selection of the interest rate assumption. However, if investment policy or asset mixes are factored in, contractors might be motivated to revise their investment policy in a manner that would allow their PPA required contributions to be assignable more rapidly. We believe that investment policy should not be driven by accounting standards but instead should be driven by asset/liability considerations.

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

Assuming that the Board is interested in adopting modern "going concern" accounting, as suggested by financial accounting standards, GDC believes it is appropriate to anticipate future salary increases. In addition, for purposes of conforming to maximum deductible limits, the CAS should reflect the PPA and permit the recognition of future salary increases.

(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?

GDC believes that the current CAS rules would generally permit the use of the mortality table required for use by the PPA and accordingly see little need for further consideration. However, the Board should understand that it is generally flawed to expect that a contractor can project future mortality as it might apply to the contractor's workforce which is more realistic than the mortality being predicted for the United States as a whole. Accordingly, we believe that the Board should revise the CAS so that contractors are able to adopt mortality tables that reflect industry wide practices without any additional requirement that it reflect the contractor's emerging experience.

(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?

At a minimum, we believe that amortization periods of no more than seven years should be permitted for all purposes. The current amortization rules under CAS are a direct reflection of the permitted amortization periods when ERISA was initially adopted. Now that the PPA has uniformly changed the amortization periods for minimum funding to seven years, there appears to be no basis to justify continuation of the current amortization periods. The Board may choose to permit contractors to continue to use longer periods but should recognize that such a decision would reduce the consistency of costs among contractors without any apparent benefit. In any event, the CAS should deem changes to a seven year period, even if just permitted and not required, as a required change for equitable adjustment purposes. However, in the event that the Board is unable to deem such a permitted change as required, the Board should require the use of a seven year amortization period for all purposes.

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

GDC believes that the asset valuation methods acceptable under the PPA are acceptable under the asset valuation methods currently permitted by the CAS and accordingly see little need for revision. However, as is the case with revisions in the amortization periods, the CAS should deem changes in the asset valuation method needed to comply with the PPA to be required changes for equitable adjustment purposes—provided that if the Board is unable to deem such treatment, the Board should restrict acceptable asset valuation methods to those that would be acceptable under the PPA for minimum funding purposes.

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

We see nothing in Congress' charge to suggest that harmonization should differentiate between the minimum funding requirements for "at risk" plans and other plans. Accordingly, we believe that minimum contributions required for "at risk" plans should be assignable costs even if they exceed the minimum contribution that would be required if the plan were not "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?

GDC believes that the cash flow mismatch is the primary issue that harmonization needs to address. This cannot be over emphasized. That said it should not be misconstrued that the CAS Board is adjusting CAS 412 and 413 to address contractor cash flow issues. Rather, the CAS Board is fulfilling its obligation to Congress to fully harmonize CAS to PPA thereby supporting, instead of undermining, the primary objective of the PPA which is to bolster the security of the private pension system. If there were no cash flow mismatching, or if Congress had been unconcerned about it, Congress would have had little need to require harmonization. Accordingly, failure to address the cash flow discrepancies between these two

methodologies and the associated impacts on the Government and contractors would be tantamount to failing to achieve the objective of harmonization.

The FAR already recognizes that pension costs incurred by contractors in fulfilling government contracts are costs that are appropriate for reimbursement by the government. CAS 412 and 413 simply set forth the manner in which these costs are assigned to accounting periods in which government contracting is performed. Unless the costs are assigned to accounting periods in a manner which facilitates recovery coincident with or close to the accounting periods in which the cash contributions are required, harmonization cannot be achieved.

As a final point, the harmonization is not only a contractor cash flow issue as your question suggests, but it is also a government procurement issue, which will directly affect its ability to procure goods and services from the contractor community. Unless department and agency budgets are adjusted to take into account the large increases in pension costs that are anticipated to occur under harmonization, serious programmatic effects in the future could develop if program dollars need to be diverted to reimbursement of pension costs. This is exacerbated by the DoD's current position that prevents contractors from projecting and bidding PPA harmonization costs on future contracts.

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

The current prepayment provisions are completely insufficient in mitigating contractors' cash flow concerns introduced by the minimum funding requirements under the PPA. Even under pre-PPA funding rules, the current prepayment provisions do not provide any firm assurance that contributions required for minimum funding will become assignable in a timely, predictable manner. As a result, under the PPA assignability might be delayed so long that for practical purposes the cash flow mismatch becomes permanent.

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

At a minimum, the CAS would need to include an amortization of prepayment credits as an independent and additional component in determining assignable costs to produce any meaningful mitigation of contractors' cash flow concerns. Such an independent component would require assignability even if the plan's regular assignable cost limit would produce a zero assignable cost under the "regular" cost determination.

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

Since it is our understanding that the Board is constrained to establishing the basis for assigning costs to the current accounting period, we presume the focus of this question is to assess the impact that harmonization might have on the consistency of costs from period to period.

Under current CAS rules, the primary source of volatility in assignable costs is the uncertainty of whether the full funding limitation under ERISA or the assignable cost limits under the CAS will apply. In either situation, this uncertainty hinges on the uncertainty of the actual return on plan assets. With respect to this, the PPA actually reduces uncertainty because it increases the maximum permissible level of funding before the full funding limitation applies. If the CAS rules are revised to reflect these increased maximum funding levels they should reduce volatility in this regard.

A new area of volatility potentially introduced by the PPA is volatility due to the valuation of liabilities based on market assumptions. As a result of this new requirement, under certain circumstances, required contributions will exhibit greater fluctuations solely due to changes in prevailing interest rates. This volatility can be greatly mitigated by proper asset strategies whereby asset returns are dependent on interest rate fluctuations in a manner similar to the manner in which the fluctuations affect the value of liabilities. However, it is our belief that such mitigation strategies should remain within the purview of the contractor as one technique among many that might be utilized to best manage its business. It should be understood however that such mitigation strategies may lead to contractors implementing more conservative investment policies, which are likely to generate lower average asset performance than experienced over the recent past by many contractors.

A second area of volatility introduced by the PPA is the potential elimination of minimum required contributions in situations where the actuarial value assets exceed the target funding level by at least the target normal cost in a year. Two primary components affect this volatility; actual asset returns and fluctuations in the interest rates required to be used to value the liabilities. To a certain degree the averaging of assets values and interest rates help to reduce this volatility. However, the Board should be cognizant that the primary display of this volatility is only in the minimum required contribution and the maximum deductible contribution. The Board can largely avoid the impact of this volatility by permitting the determination of assignable costs to fall within the range of minimum and maximum contributions and refraining from the temptation to set the assignable cost equal to the minimum required contribution under the PPA. This range might take into account a number of factors including recognition of salary increases beyond the current cost accounting period and offsetting the target normal cost by overfunding on an amortized basis instead of a dollar for dollar basis.

(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?

We believe that in harmonizing with the PPA, the assignable cost limitation should be revised to reflect the maximum deductible limits but as modified by the PPA. The current CAS assignable cost limitation is described in terms of the full funding limitation. Prior to the PPA, the full funding limitation established the maximum amount above which contributions are not deductible. Therefore recalibrating the assignable cost limitation with the PPA maximum deductible limits would be consistent with the PPA harmonization process.

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

Currently under CAS if negative pension costs are developed, they are set to zero. On an overall plan basis, we see no reason why harmonization should change this practice. However, on a segment by segment basis within a plan that covers multiple segments, the Board might consider permitting negative costs within one or more segments with the proviso that overall the plan assignable cost cannot be less than zero. If the CAS prescribes such a practice, it should be understood that the effect will be to reallocate assets from one segment to another. This reallocation might result in assets arising from funding by one arm of the Government being transferred to another arm of the Government and from one contract to another contract. Viewed from a budgeting and cost allocation perspective, this result may be both impractical and unworkable.

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)?

GDC believes that full harmonization of CAS 412 rules to the PPA would greatly obviate the need for segment closing adjustment calculations under CAS 413 since on an ongoing basis assets and liabilities

are annually being marked to market. However, at a segment closing it should be expected that differences between the PPA funding target and the plan assets would exist and still need to be accounted for. Furthermore, while the assumptions mandated by the PPA are more representative of settlement rates, it should continue to be anticipated that the cost of annuity purchases or other settlement approaches will not be fully captured through use of the PPA funding assumptions. Finally, the continued appropriateness of the requirement under CAS 413 that the assumptions be consistent with current and long term assumptions would seem to need review.

(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?

Unless CAS 413-50(c)(12) is amended, we believe that cessation of benefit accruals resulting from a funding target attainment percentage of less than 60% could be construed as requiring a segment-closing adjustment. This would seem inconsistent with the purpose of these provisions since accruals would normally automatically resume when the funding percentage equals or exceeds 60%. In fact, the CAS 413 adjustment provides a ready mechanism for ensuring this level is achieved as the adjustment mechanism represents a definite source of cash that could be used to fund the plan over and above what minimum funding might require. In other words, if an "at risk" plan status triggers the segment closing adjustment, the Government's share of the adjustment would provide the contractor with a source of cash to contribute to the plan to bring it out of the "at-risk" status. While this would benefit the plan, we do not think that it reflects the intent of the CAS 413 adjustment. Accordingly, we believe that CAS 413 should be revised to exclude treating curtailment of benefits solely due to the "at risk" rules in the same manner as other plan curtailments.

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?

GDC believes that the manner in which prepayment credits are adjusted should be reflective of the manner in which the CAS is harmonized with the PPA. In particular, if CAS is harmonized to an interest rate methodology similar that used under the PPA, use of the pension fund's actual return on assets is likely to be appropriate. However, if harmonization retains in some manner the concept that an expected return on invested assets should continue to be utilized then it may be appropriate to use that same expected return for adjusting prepayment credits.

(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?

GDC believes that interest adjustments should be computed based on the actual date of deposit although we would encourage the Board to permit reasonable approximations so as to avoid undue complications and unneeded precision. However, it should be noted that under FAR 31.205-6(j)(2)(iii) interest adjustments for contributions made beyond 30 days after the end of each quarter are unallowable and hence are not assignable.

(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 rules should be revised to reflect these rules with the expectation that it will have minimal impact on costs but would eliminate a potential source of inconsistency with an administrative

cost far outweighing any potential benefit. Under the PPA, the recognition of established patterns of collectively bargained benefits is exclusively associated with the determination of maximum deductible limits and is consistent with the recognition of future period salary increases for this purpose. However, if the CAS rules fail to recognize established patterns of collectively bargained benefits, situations could arise in which otherwise assignable costs might be restricted.

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

For determining the maximum deductible limit, the PPA limits the expected rate of increase to the average annual rate over the preceding six years. We encourage the Board to adopt the same standard.

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.

GDC is currently participating in various industry-wide studies/surveys examining the estimated costs associated with the PPA minimum required contributions. According to some initial industry studies it appears that there are significant cash contribution differences between the funding requirements of PPA and CAS. Under current CAS, it is unclear whether any contractor would ever recover these prepayment amounts. GDC understands the delicate balance of program funding and the appropriations process; however, Congress balanced these interests when enacting PPA. Congress required CASB to change its rules to reflect the provisions of PPA. Any additional costs imposed on contractors without appropriate recoverability would, in essence, require contractors to finance a portion of the cost of providing goods and services to the government.

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?

We believe that current practices/rules result in sufficient documentation and therefore do not believe that additional requirements should be considered by the Board.