DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

# 05 DCAA
Rec'd 11/03/2008 2:50 PM

IN REPLY REFER TO

PAC 730.8.A.05/2009-01

November 3, 2008

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

SUBJECT: "CAS Pension Harmonization ANPRM"

Dear Mr. Wong:

We are providing our comments on the Advance Notice of Proposed Rulemaking (ANPRM) – Harmonization of Cost Accounting Standards (CAS) 412 and 413 with the Pension Protection Act of 2006 (PPA), in response to the notice published in the September 2, 2008 Federal Register.

We recommend that the CAS Board not adopt the proposed provision for annual amortizations of mandatory prepayment credits. We believe that the proposed mandatory prepayment credit provision, which is intended to provide an additional relief for a "negative cash flow" that the contractor may experience in early years, is superfluous and unnecessary, and is difficult to ensure compliance. In our opinion, harmonization of the CAS with the PPA has been achieved sufficiently in the ANPRM that recognizes the PPA liability, reduction in the amortization period for gains and losses, and increase of the assignable cost limitation.

As elaborated below, we believe that the accounting record keeping required for the proposed mandatory prepayment credits is unduly complex, burdensome, and unnecessary to achieving harmonization. Current CAS recognizes prepayment credits without distinguishing voluntary from mandatory prepayment credits. Moreover, the proposed creation of a mandatory prepayment account requires separate identification, accumulation, amortization, interest accrual, and other adjustment of mandatory prepayment credits for each year. This process will increase administrative costs, be prone to error, and be very difficult to validate the accuracy and compliance during audit. In our view, harmony with funding differences already exists in the current CAS provision for prepayment credits that will increase in value at the valuation rate of return for funding of future pension costs.

## I. Separate Accounting for Mandatory Prepayment Credits

Current CAS 412 defines prepayment credits as "the amount funded in excess of the pension cost assigned to a cost accounting period that is carried forward for future recognition." As defined, prepayment credits stem from the timing and amount of the funding of periodic pension cost. Although the ANPRM begins with this definition, prepayment credits are then bifurcated as either mandatory or voluntary. Mandatory prepayment credits, the term introduced in the ANPRM for the first time, are created when the PPA minimum required funding exceeds the CAS cost as measured and assigned under the ANPRM in any given year. Any other additional funding is regarded as a voluntary prepayment credit.

Mandatory prepayment credits created in an accounting period are to be accumulated in a "mandatory prepayment account" and amortized and recognized, with interest, as an additional component of pension cost beginning with the period following creation of the credit. Should the CAS assigned cost exceed the PPA minimum required funding, the difference is to be funded by first using the current period amortization of mandatory prepayment credits, i.e., the "mandatory prepayment charge," and, thereafter, applying any unamortized balances in the order in which the mandatory prepayments were created. The result of these calculations is the "applied mandatory prepayment," meaning the mandatory prepayment credits used to fund the assigned pension cost. Note that interest, at the long-term assumed interest rate, continues to accrue on the mandatory prepayment account balance. These accounting requirements will necessitate creation of a schedule detailing beginning mandatory prepayment credit balances, annual amortization, interest accrual, mandatory prepayments applied, other adjustments, and ending prepayment credit balances. If no mandatory prepayment credits are available in a given period, then the voluntary prepayment credits will be applied. Because the annual amortization of mandatory prepayment credits is mandatory, because differences between the PPA minimum funding and the CAS assigned cost are created each year, and because the ANPRM specifies the order in which layers of mandatory prepayment credits must be used, the associated accounting will require specific identification of the year in which each layer of amortization of prepayment credits and related unamortized balance are originated. We believe the additional requirement for separately identifying and maintaining this "mandatory prepayment account," separate from "voluntary prepayment account," will be costly and overly burdensome to both contractors and the Government.

Mandatory prepayment credits may be reimbursed under Government contracts as an added component of annual pension cost, i.e., the separately identified "mandatory prepayment charge." Whereas annual recovery of amortizations of the mandatory prepayment credits improves a contractor's cash flows in initial years, it does not augment harmonization in the amount of pension cost as determined under CAS and the PPA.

We believe that any "negative cash flow," or PPA-required funding in excess of the ANPRM measured pension cost in early years, should be considered an investment similar to a savings account and will earn interest at the assumed rate-of-return (or at the actual rate-of-return as proposed in the ANPRM). The "negative cash flow," which would be much smaller due to the ANPRM recognition of the PPA liability, also will be mitigated to the extent the contractor can reduce its income tax liability from increased deductions for PPA funding. In our view, this "negative cash flow" is similar to acquisition of capital assets such as buildings, land or equipment, for which the contractor must finance the acquisition but, in accordance with CAS 409, measures for contract costing purposes only, a portion of the asset resource consumed in each accounting period as depreciation expense. A variance, between an immediate cash outlay for the acquired capital asset and the amortized cash recovery through depreciation over time, is mitigated by recognition of CAS 414 "cost of money" for the undepreciated value of the asset. CAS 414 "cost of money," which is an imputed interest on the not-yet-recovered cash outlay, is equivalent to the earnings on prepayment credits at the assumed rate-of-return provided in current CAS 412.

Finally, the new PPA funding rules went into effect for plan years beginning after 2007 unless a Defense contractor qualifies for an exception pursuant to Section 106, which provides delayed implementation at the earlier of the effective date of the CAS Pension Harmonization Rule or January 1, 2011. Except for certain large Defense contractors that are permitted for delayed implementation, contractors are required to implement the PPA beginning in 2008. Their minimum required contributions under the PPA would likely exceed the CAS assigned cost resulting in "mandatory prepayment credits." To avoid any disparity and attain a fair playing field for all contractors, we recommend recognition of mandatory prepayment credits that are created as a direct result of the implementation of the PPA during the period between 2008 and the effective date of the CAS Harmonization Rule. The method for recognizing these "mandatory prepayment credits" under Government contracts is provided in the Phase-in provision of the ANPRM. We believe that recognition of mandatory prepayment credits as an additional component of assignable pension costs should be limited to these specific circumstances.

## II. Recognition of the PPA Liability

CAS is based upon the "going-concern" concept that the company and its pension plan will continue in operation indefinitely. Accordingly, accounting for pension costs should reflect a long-term perspective, using a diversified debt and equity portfolio having a long-term rate-of-return to provide consistent and reasonable cost data for forward-pricing contracts. In contrast, the PPA espouses a "settlement" or "liquidation" approach, which presumes that a company and its pension plan are subject to economic environments with uncertain financial conditions that necessitate a conservative investment rate-of-return based solely on high quality bonds. Consequently, valuing pension plan assets and liabilities under the PPA involves use of interest rates based upon current corporate bond rates.

The Federal Register Notice discussion of Supplementary Information at B. Background and Summary, states that "the Board recognizes that contract cost accounting for a going concern must, nevertheless, address the risk associated with inadequate funding of a plan's settlement liability and, therefore, proposes implementation of a minimum liability based on the accrued benefits valued based on corporate bond rates." Accordingly, the Board proposed implementation of a minimum pension liability based upon accrued benefits valued using rates-of-return of high quality, corporate bond rates of similar duration to the plan benefits. The result is the "CAS Harmonization Rule" proposed at 9904.412-40(b)(3), which measures a liability adjustment amount equal to the excess of the PPA minimum actuarial liability over the CAS-computed, actuarial accrued liability for the period. The actuarial accrued liability plus the liability adjustment amount equals the adjusted actuarial liability. Likewise, a normal cost adjustment amount is similarly measured and the normal cost plus the normal cost adjustment amount equals the adjusted normal cost for the period. The results of these adjustments, in effect, are to recognize the PPA pension liability.

One of the public comments to the Staff Discussion Paper (SDP) underscored the significance of the CAS rules adopting the PPA liability, as follows:

> If the CAS rules are changed to allow (or require) the use of the same liability determination, including discount rate and mortality assumptions as will be required under PPA, most of the other differences between CAS and PPA annual cost determinations would be viewed as minor. We believe that this is the single most important item for harmonizing the CAS rules with the new PPA minimum funding requirements. The CAS rules should be revised to use the same liability and normal cost amounts as used in the new PPA funding requirements.

We fully agree with this comment that the ANPRM's recognition of the PPA liability, which is determined by using its required interest rate and mortality assumptions, will substantially close the differences between CAS and PPA cost determinations. All other differences would be minor. Accordingly, we believe that the ANPRM's recognition of the PPA liability alone would accomplish the Congressional mandate for the CAS Board to harmonize the CAS with the PPA. Since the interest rates of corporate bonds are typically less than long-term expected investment rates-of-return of a diversified, bond and equity portfolio as espoused by CAS, the "harmonized" minimum actuarial liability will generally be greater than the CAS-computed actuarial accrued liability. This larger liability will result in a larger unfunded actuarial liability which, in turn, will measure and assign greater pension cost allocable to Government contracts. Recognition of greater pension costs creates greater funding of the pension plan that will provide the funding level required for settling pension obligations under the plan.

In conclusion, we believe that the ANPRM provisions, which recognize the PPA liability, reduce the amortization period for gains and losses from 15 to 10 years, and increase the assignable cost limitation by 25 percent, have the effect of making the annual CAS-assigned cost a lot closer to the PPA required funding in early years and potentially making the CAS cost exceeding the PPA required funding in later years. The proposed provision for annual mandatory prepayment charges is superfluous and unnecessary since the "negative cash flow" that may result from the PPA-required funding in excess of CAS-assigned cost in the early years is adequately provided for in the current CAS. Further, the associated accounting requirements are complex and difficult to ensure contractor compliance. Accordingly, we recommend that the CAS Board not adopt the provision for annual mandatory prepayment charges.

We appreciate your consideration of our comments. Please direct any questions regarding this memorandum to Ms. Fran Cornett, Chief, Accounting and Cost Principles Division (PAC) at (703) 767-3250.

Kenneth J. Saccoccia
Assistant Director
Policy and Plans