GENERAL DYNAMICS

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Cost Accounting Standards Board
Attention: Raymond Wong
Office of Federal Procurement Policy
725 17th Street, NW, Room 9013
Washington, DC 20503
Via e-mail to casb2@omb.eop.gov

Reference: CAS Pension Harmonization ANPRM, CAS-2007-02S

Dear Mr. Wong:

Presented below is General Dynamics Corporation's (GDC or we) response to the Cost Accounting Standards (CAS) Board's Advance Notice of Proposed Rulemaking (ANPRM) issued in the Federal Register of September 2, 2008. We believe the CAS Board's ANPRM is generally fair and balanced, and reflects a solid effort to tackle a very technical issue.

GDC generally agrees with the content of the Aerospace Industries Association (AIA) and the National Defense Industrial Association (NDIA) joint response to the ANPRM; however, we would like to supplement that letter with some additional thoughts and considerations concerning; 1) the effective date of the revised Standards, 2) the need to make certain portions of the revised Standards a 'required change', 3) the need to provide a vehicle to facilitate the transfer of voluntary prepayment credits to mandatory prepayment credits, and 4) a concern regarding the assignment of mandatory prepayment charges among segments.

1. Effective Date of the Revised Standards

In order to illustrate our concerns, it may be helpful to describe our understanding of the sequence of events that need to occur before the harmonization rules become effective for a contractor:

1. The new rules are published in the Federal Register. This is required by the PPA to occur no later than January 1, 2010.
2. The published rules must state an effective date of the new rules. The ANPRM suggests that this date is intended to be the date published, i.e. in 2009. Under the

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Federal Procurement Policy requirements for promulgating cost accounting standards, the effective date must be "within 120 days after publication in the Federal Register in final form, unless the Board determines a longer period is necessary" (41 USC 422(g)(2)). This suggests that the effective date can be later than the date that the rules are published.

3. On or after the effective date of the new rules, a contractor must receive a new contract or subcontract subject to CAS.
4. The contractor begins applying the new rules in the first accounting period starting after the new contract.

Given the remaining steps involved in the promulgation process, it is our expectation that the final rules will be published no earlier than near the end of 2009. Assuming a calendar year accounting period, this suggests that a contractor who receives a new contract at the end of 2009, but after the final rule is published would become subject to the new rules almost immediately on January 1, 2010. A January 1, 2010, effective date does not allow sufficient time for contractors to revise their pricing data to take into account the final rule. This would be particularly burdensome for large contractors who are receiving new contracts on a daily basis.

Yet, under the above scenario, if the new contract were delayed just a short period of time until early 2010, the same contractor might not become subject to the new rules until 2011. Also note that contractors who receive new contracts fairly infrequently, which would be more typical of many smaller contractors, are more likely to become subject to the new rules in 2011.

In order to remedy these inconsistencies in the effective date, we ask the CAS Board to consider delaying the effective date until a date after January 1, 2010. Recognizing the magnitude of the proposed changes, we believe that the full 120 day delay expressly provided under Federal Procurement policy is fully justified. Operationally, this would make 2011, as the effective date for most contractors. This effective date also would be more consistent with the approach used in 1995, which included a March 30, 1995, effective date, 9 months before most contractors were required to apply the new rules.

However as a side concern, note that while an effective date of January 1, 2010, would delay applicability until 2011 for most contractors, it would require application of the Pension Protection Act of 2006 (PPA) rules for eligible government contractors to expire in 2010, one year prior to when the harmonization rules would apply. We do not believe that this inconsistency was intended by Congress. Accordingly, we ask that the CAS Board refrain from setting an effective date prior to January 2, 2010.

Suggested language (in red) to 9904.412-63(c) and 9904.413-63(c) might be as follows:

"Contractors with prior CAS-covered contracts with full coverage shall continue to follow the Standard in 9904.412 in effect prior to [Date published in the Federal Register], 2009, until this Standard, effective [120 days after Date published in the Federal Register], becomes applicable following the receipt of a contract or subcontract to which this Standard applies."

This modification would appear to be in compliance with the PPA since it both requires the harmonization rules to be adopted before January 1, 2010, and requires compliance with the PPA rules by eligible contractors to occur no later than January 1, 2011.

To avoid inequitable results, we also request that the CAS Board confirm that the proposed delay in effective date until sometime after January 2, 2010, would not preclude contractors from pricing contracts under the new CAS rules for 2011, and forward, so long as the contractor reasonably anticipates receipt of a new CAS-covered contract or subcontract after the effective date and prior to the end of 2010.

2. Required Changes

The response to item 19 in the background and summary of the ANPRM indicates that new rules would be mandatory changes. However, this is not specified in the proposed rules themselves. Recognizing the significant impact of the changes being introduced, we would suggest to ensure that the portions of the new rules, which should be treated as required changes be clearly identified. Accordingly, we ask the CAS Board to consider adding additional language (in red) to 9904.412-63(d) and 9904.413-63(d) such as the following suggestion:

" All changes to a contractor's cost accounting practices required to comply with the revisions to the Standards in 9904.412 as published [Date published in the Federal Register] shall be treated as required changes in practice as defined under 9903.201-6(a) to be applied to both existing and new contracts"

3. Transfers of voluntary prepayment credits

As the proposed rules are currently written, mandatory prepayment credits can only arise in situations in which the contractor is required to make a contribution in excess of the assignable cost due to minimum funding requirements under ERISA. Other contributions in excess of the assignable costs will be treated as voluntary prepayment credits. Two key differences exist between the treatment of mandatory and voluntary prepayment credits. First, mandatory prepayment credits are credited with interest at the long-term assumed rate while voluntary prepayment credits are credited with interest at the actual rate of return. Second, mandatory prepayment credits have guaranteed assignability (assuming ongoing contracting) while voluntary prepayment credits are only assignable when, and if,

the assignable costs are in excess of the minimum required contributions and, in addition, all mandatory prepayment credits have been exhausted. We believe there are many scenarios in which the voluntary prepayment credits will never be recovered.

While in the abstract, this may not appear to be of concern to the CAS Board, this dichotomous treatment essentially punishes contractors who choose to bolster their plan's funding (i.e., PPA's intent) in anticipation of the burgeoning cash costs under PPA, particularly in light of the current economic environment. Without some mechanism for converting voluntary to mandatory prepayment credits, contractors have a disincentive to make contributions to their plans that may be considered prudent absent these penalizing provisions.

To alleviate this disincentive, we advocate the CAS Board to adopt a twofold mechanism to provide contractors with a means of transferring voluntary to mandatory prepayment credits in the event that these voluntary contributions serve to reduce the mandatory prepayment credits that would otherwise be created. We recognize that the CAS Board may have a concern that contractors would abuse such a provision and knowingly over-contribute to their plans with the expectation that full assignability will be available. While we believe that the realities of corporate finance and competitive contracting essentially eliminate such abuses, we can understand the desire of the CAS Board to protect against any abuse through appropriate regulation.

The first part of the twofold mechanism would only apply in situations in which a contractor has both a voluntary prepayment credit and ERISA credit balances, utilizes the ERISA credit balances to satisfy ERISA funding requirements, and has ERISA minimum funding requirements in excess of the assignable CAS cost. In this situation, the amount transferred to the mandatory from the voluntary prepayment account would equal the portion of the ERISA credit balances used to satisfy minimum funding, but not in excess of the balance in the voluntary prepayment account.

The second part of the mechanism would address situations in which the contractor has a voluntary prepayment account in excess of the ERISA credit balances. This situation could occur due to situations in which the operation of the ERISA credit balances are not mirrored in the voluntary prepayment account. For example, in some situations an employer is required to surrender the credit balances in order to maintain certain funding percentages in a plan. Under this mechanism, a portion of the voluntary prepayment account would be re-characterized as a mandatory prepayment credit. This portion would equal the increase in the ERISA required contribution that would have resulted if the voluntary prepayment were never contributed. This is accomplished by calculating an adjusted ERISA required contribution using an asset value with the balance of the voluntary prepayment account subtracted out.

With this in mind, we believe that the following modifications to the definitions and

illustration would adequately address this concern (in red):

"(15) **Mandatory prepayment credit** means the amount of the minimum required funding in excess of the pension cost assigned to a cost accounting period. **Mandatory prepayment charge** means the minimum amount of a mandatory prepayment credit that is applied towards funding of the assigned pension cost or separately allocated to cost objectives. **Applied mandatory prepayment** means the mandatory prepayment credits used to fund the assigned pension cost. **Mandatory prepayment account** means the value, as of the measurement date, of the mandatory prepayment credits adjusted for interest at the long-term assumed rate of interest, decreased by applied mandatory prepayments and separately allocated mandatory prepayment charges during the current period and increased by the prepayment account transfer."

"(28) **Voluntary prepayment credit** means the amount of the minimum required funding in excess of the pension cost assigned to a cost accounting period. Applied voluntary prepayment means the voluntary prepayment credits used to fund the assigned pension cost. Voluntary prepayment account means the value, as of the measurement date, of the voluntary prepayment credits adjusted for interest at the actual investment rate of return and decreased by the prepayment account transfer and applied voluntary prepayments during the current period."

"(29) **Prepayment account transfer** means (a) the lesser of the voluntary prepayment account and the ERISA credit balances used to satisfy minimum funding requirements, plus (b) the voluntary prepayment adjustment. **Voluntary prepayment adjustment** means the excess, if any, of the difference between the mandatory prepayment credit for the cost accounting period over the adjusted mandatory prepayment credit, both determined as of the measurement date. The **adjusted mandatory prepayment credit** means an amount determined in the same manner as the mandatory prepayment credit except that the assets used in such determination are reduced by the excess, if any, of the voluntary prepayment account over the ERISA credit balances as of the measurement date."

Illustration: "(18) Assume the same facts for Contractor O in Illustration 9904.412-60(c)(14) except that Contractor O has a voluntary prepayment account balance of $200,000 and has no remaining credit balances. Subtracting the voluntary prepayment account balance from the assets used to determine the mandatory prepayment credit produces an adjusted mandatory prepayment credit of $134,000. The prepayment account transfer is $34,000 ($134,000 - $100,000). In accordance with 9904.412-30(15) this $34,000 is added to the mandatory prepayment credit for a total amount of $134,000 as of the first day of the plan year and is carried forward to the end of the plan year at the long-term assumed interest rate in accordance with 9904.412-50(a)(4)(i)(B). Simultaneously, the prepayment account transfer reduces the voluntary prepayment account balance to $166,000 ($200,000 - $34,000) as of the first day of the plan year and is carried forward

to the end of the plan year using the actual rate of return in accordance with 9904.412-50(a)(4)(ii)(B)."

Note that these changes require a transfer of voluntary prepayment credits to the mandatory prepayment account only to the extent that the voluntary prepayment account causes a reduction in the otherwise required mandatory prepayment credits, and only in the amount of the relief provided by the recognition of the voluntary prepayment account when determining the PPA minimum required contribution in that accounting period.

4. Distribution of mandatory prepayment charges among segments

Special consideration is required when addressing the treatment of prepayment charges and credits in situations in which a plan maintains more than one segment. The proposed rules suggest that such apportionment is done in manner similar to how the maximum deductible contribution is allocated. However, this approach does not work very well primarily because the maximum deductible contribution imposes a limit on the otherwise assignable cost, which the prepayment charges represent an addition to the otherwise assignable cost. Furthermore, while the maximum deductible contribution is primarily related to annual costs, the prepayment charges are generated through the underfunding of some segments. Accordingly, we believe that the apportionment of the prepayment charges is more appropriately related to funding levels. While such underfunding is often associated with higher annual costs, there is a much stronger relationship to funding levels.

However, before addressing this further, we think that the CAS Board needs to clarify that the voluntary and the mandatory prepayment accounts be maintained separately and not be apportioned to individual segments. This request is based on our understanding that the intention is for apportioning to occur when these accounts are allocated as part of the assignable cost. The remainder of our comments concerning the distribution of prepayment charges among segments is predicated on this understanding.

In modeling how such an allocation among segments might work, it became apparent that due to the amortization periods involved, the charge to be allocated in one year may have arisen from segments that are now well funded and that may now have zero assignable cost limitations. It also became apparent that mandatory prepayment charges might need to be allocated in years when every segment has zero assignable cost limitations. Finally, it became apparent that some segments could have their funding levels bolstered above their minimum liability while other segments may continue to underfunded on a PPA basis. It is due to these operational inconsistencies and concerns that we ask the CAS Board to expand the rules addressing how the mandatory prepayment charges are apportioned among segments.

In order to address these concerns, we propose a two-step process to be used when

apportioning mandatory prepayment charges among segments. The first step would be to allocate the charges proportionately among the segments based on the difference between each segment's assignable cost limitation and its otherwise determined assignable cost. In this first step, the maximum amount allocated overall would not exceed the sum of these differences. In this manner, the apportionment potentially increases the assignable cost limit of each segment up to its assignable cost limit. The second step would allocate any remaining mandatory prepayment charge in proportion to the sum of the assignable limitations for each segment of the plan determined as if the each segment's assets were equal to zero. In this manner the remaining charge would be allocated so that the level of overfunding is kept equal among all of the segments.

To reflect these changes we propose that the CAS Board to consider making the following changes (in red):

1. Revise 9904.413-50(c)(1)(ii) to read as follows:

"(ii) When apportioning amounts deposited to a funding agency (excluding amounts treated as mandatory prepayment credits and voluntary prepayment credits) to segments, contractors shall use a base that is representative of the assignable pension costs, determined in accordance with 9904.412413-50(c) for the individual segments. However, for qualified defined-benefit pension plans, the contractor may first apportion amounts funded to the segment or segments subject to this Standard."

2. Revise 9904.413-50(c)(1)(iii) to read as follows:

"(iii) The mandatory prepayment account and voluntary prepayment account shall be accounted for separately and not apportioned among segments until assignable."

3. Add a new 9904.413-50(c)(1)(iv) to read as follows:

"(iv) For qualified defined-benefit pension plans, contractors shall apportion to segments the sum of the mandatory prepayment charge and the assigned mandatory prepayment adjustment, computed in accordance with 9904.412-50(a)(4)(i)(D) as follows. First, an allocation base shall be determined for each segment equal to the difference between the segment's assignable cost limitation and the assignable costs prior to inclusion of the mandatory prepayment charge and the assigned mandatory prepayment adjustment. Second, the sum of the mandatory prepayment charge and the assigned mandatory prepayment adjustment, not in excess of the total of these allocation bases for all of the segments, shall be proportionately allocated among the segments using the allocation bases. Third, the allocation bases shall be redetermined to equal the assignable cost limitation calculated as if each segment had zero assets. Fourth, any remainder of the mandatory prepayment charge and the assigned mandatory prepayment adjustment not

already allocated shall be allocated in proportionately among the segments using the redetermined allocation bases. "

Adoption of rules concerning the apportionment of prepayment charges similar to those described above would enhance consistency among contractors, and help to facilitate more equal levels of funding among all segments within a plan.

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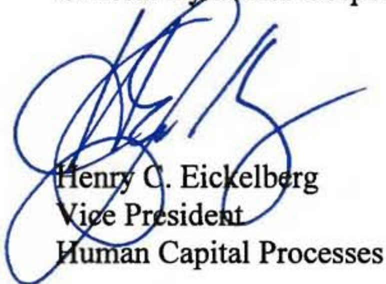
We hope our comments and thoughts to the ANPRM will help the Board understand and appreciate our concerns. We are committed to working together during the next stages of the rulemaking process. We appreciate the opportunity to provide our views on these important issues.

Sincerely,

General Dynamics Corporation



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