

Fact-Finding Public Comments for Adjustment and Allocation of Pension Costs for Segments
Closings, Curtailments, and Terminations

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**COMMITTEE ON GOVERNMENT BUSINESS
COMMITTEE ON BENEFITS FINANCE**

September 5, 2013

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

Subject: Comments pursuant to request made at the July 31 & August 14, 2013 Public Meetings regarding the Cost Accounting Standards: CAS 413 Pension case at the CAS board.

Dear Mr. Wong,

The Financial Executives International's ("FEI") Committee on Government Business ("CGB") and the Committee on Benefits Finance ("CBF") appreciate the opportunity to provide comments regarding a potential rule change in the Cost Accounting Standards: CAS 413 Pension Adjustments for Extraordinary Events.

The FEI is a professional association representing the interests of more than 15,000 chief financial officers, treasurers, controllers, tax directors, and other senior financial executives from over 8,000 major companies throughout the United States and Canada. FEI represents both the providers and users of financial information. The CGB formulates policy opinions on government contracting issues and the CBF formulates policy opinions on employee benefits issues (including pensions) for FEI in line with the views of the membership. This letter represents the views of these Committees.

A number of our Committee members participated at the public meetings held on July 31 and August 14 at the Professional Services Council offices in Arlington, VA. We first would like to express our gratitude to the Board in having these public meetings. We found them to be well attended by knowledgeable individuals, from multiple constituencies which enabled a robust, candid and productive discussion of the issues. This transparency and involvement of the public in the rulemaking process is a "best practice" that will in the end result in better rulemaking and the administration of those rules as we go forward.

During these meetings the CAS board working group requested that comments or issues that were discussed be captured and submitted in writing to the board in accordance with July 8, 2013 federal register notice. To that end below are items the FEI CGB & CBF submit from the discussions that we feel merit further consideration by the Board;

Elimination of CAS 413-50(C)(12)

The question was posed and discussed at the meetings if this rule should be eliminated as being unnecessary in today's environment.

The rule should not be eliminated. The basis under which it was established remains and is an appropriate cost accounting treatment for settlement purposes. Because of the nature of how CAS pension costs are recognized in contracting there must be a settling of pension costs when a plan is terminated or a contractor ceases to be involved in Government business. The peculiarities of CAS pension calculations layer costs related to prior year gains and losses associated with pension assets (i.e. pension cost smoothing). A settlement adjustment is necessary to recognize variations from those prior periods to ensure both the Government and the contractor have equitably recognized their mutual pension obligations from the contractual relationship that is ending.

Curtailments

Several actuaries at the public meeting discussed the view that curtailments should be treated as plan amendments not as a segment closing adjustment under CAS 413-50(c)(12). There appeared to be a widely held view that the 1995 update to CAS 413 was in error for making this change. An undesirable effect of that has been to hamper contractors from being able to manage aspects of their pensions to control costs through plan curtailments so as not to trip a CAS 413 segment closing adjustment.

We recommend that CAS board consider reviewing the treatment of plan curtailments under CAS 413 as part of the rule making process. Treating curtailments as plan amendments allowing for continued recognition of on-going pension cost verses triggering a plan settlement adjustment would be a desirable outcome from the rulemaking process.

"Orphan" Segments or Plans

During the meetings there was a discussion on the "soft freezes" that a number of contractors have implemented.

CAS 413-50(c)(1) states:

"For contractors who compute a composite pension cost covering plan participants in two or more segments, the base to be used for allocating such costs shall be representative of the factors on which the pension benefits are based. For example, a base consisting of salaries and wages shall be used for pension costs that are calculated as a percentage of salaries and wages; a base consisting of the number of participants shall be used for pension costs that are calculated as an amount per participant..." (Emphasis added)

By freezing plans to new participants, the population of active plan participants over time will dwindle and ultimately become zero. Contractors distributing pension costs in accordance with the above citation will face uncertainty when their active population ceases but they continue to

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measure pension costs in accordance with CAS 412. We believe that allowing contractors to distribute that “orphan” cost across the total payroll or some other rationale of the organizations previously eligible for those pensions would prevent inequitable distribution of the cost and/or a premature plan terminations. Absent guidance, there is a potential for disputes regarding the treatment of this cost. We recommend that the board evaluate if the above citation can be expanded to provide options, additionally the inclusion of an illustration in CAS 413-60, that addresses this situation would be helpful.

Mark to Market (Ref CAS413-50(c)(12)(i))

The working group posed a question if a “Mark to Market” true up was appropriate under the context of pension plan assets and liabilities having been accumulated over many years.

For segment closing adjustments the CAS board should modify segment closing calculations to be based on the MAL (Minimum Actuarial Liability) and use interest rates consistent with CAS 412-50(b)(7) the CAS Pension Harmonization rule.

As we’ve discussed above in addressing the need of segment closing adjustments, an adjustment is necessary when a pension plan ends and/or the contractor exits Government business/contracting. The peculiarities of CAS pension calculations layer cost related to prior year gains and losses associated with pension assets. A settlement adjustment will recognize variations from those prior periods to ensure both the Government and the contractor have equitably recognized their mutual pension obligations as part of a final settlement.

Using the MAL (for both qualified and nonqualified plans) is appropriate and in harmony with how pension costs are measured today for other pension calculations (CAS 412, GAAP & ERISA). Over time society’s view of pensions has evolved to where today a short term or a “mark to market” view is predominant. Congress effectively changed the contracting view of pension costs when it put into the Pension Protection Act (PPA) of 2006 the requirement for the CAS regulations to be “harmonized” with that short term view. The interest rates included in the CAS Pension Harmonization rule took steps to fulfill that Congressional mandate for CAS 412. Revising CAS 413 segment closing adjustments for this requirement will complete that process.

The nature of a segment closing has not changed; assets and liabilities are looked at, for a point in time irrespective of the age of the plan. What has changed, as noted above, is the measure of these assets, liabilities and costs to take a short term view consistent and in harmony with how pension costs are perceived and managed today.

Historical Records (Ref CAS 413-50(c)(5))

During the meetings there was discussion on the issue of the lack of discrete historical records with respect inactive plan participants, plan contributions, benefits and earnings. Contractors currently implement the CAS using reasonable actuarial estimates, in lieu of having these discrete values.

In situations where plans have been in a surplus position, these estimates have been accepted in calculating segment closings. It has only been in situations when plans are in a deficit position that oversight agencies have made an issue of the lack of records. In our opinion reasonable actuarial estimates should be acceptable irrespective of the funding status of a plan (surplus or deficit).

Contractors were not required to maintain the records, nor at the time those records were available was there an expectation there would be a need for them in the future. There were the rule changes, and the regulators strident view of those changes, that has created the perceived need for those historical records, after they became unavailable,

Absolute precision should not be a fundamental requirement for pension segment closing calculations. Pension costs and plan funding at a point in time, by its very nature is an estimate. Naturally if information is available it should be used, as is practical. However not to allow reasonable estimates in this process in some circumstances, where they are acceptable in others, is inconsistent.

Conflicts between CAS, IRC 414(l) and negotiated sales agreement with transfer of assets

The Board posed a question regarding instances when a segment is closed as a result of a sale or transfer of ownership to a successor in interest in the contracts of a segment, including the pension obligations. In general, the CAS formula for calculating the asset share to be transferred will be different from what is required under the IRC.

Contractors should not be penalized by the CAS for a conflict in these statutory requirements, the CAS should allow for the acceptance of the IRC formula regarding asset transfers for segment closing purposes.

Merging of Pension Plans and Segmented Plans

Another item discussed related to CAS 413-50(c)(3) where the CAS instructs when to account for pension plans on a segmented basis. The CAS is silent with respect to the ability to merge segmented plans to be measured with fewer segments or on a composite basis going forward. Adding flexibility into the rules to allow for segments and plans to be merged may enable the acquisition community to better manage these pension obligations and streamline administrative costs of tracking segments and plans for CAS purposes that have long since been merged for GAAP or ERISA purposes.

Timing of Submitting Segment Closing Adjustment Calculations

A recent court decision regarding the submission of CAS 413 segment closing adjustments has created challenges for CAS covered contractors that experience segment closings. That decision has resulted in a requirement for contractors to measure and submit the segment closing adjustments in the cost accounting period as of the date of the segment closing.

The nature of the actuarial calculations for these adjustments requires sufficient time to collect data and information to complete the process. Both the CAS standards and rules are silent regarding timing allowed to submit an adjustment.

The CAS rules establish the timing for when to submit a CASB disclosure statement (reference CASB 9903.202-1). It would be instructive and helpful to provide similar guidance with regard to segment closing adjustments. We feel this is a matter of measurement of the costs and not the

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administration of CAS which falls to the FAR council. If the CAS board recognizes the practical challenges to calculate these adjustments, just as they did with the timing of CASB statement filings, the FAR council could then implement any administrative rules from that point forward.

CAS 412-50(c)(2)(i) – Discussion on the “Zero” cost floor

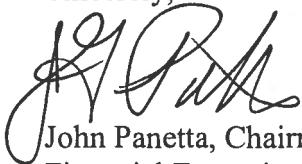
At the second public meeting while addressing the “need” for a segment closing adjustment an idea was forwarded by one of the working group members, to solicit discussion, regarding assignable cost credits. In particular the question was asked if the floor¹ in CAS 412-50(c)(2)(i) should be eliminated, thereby allowing pension credits to be recognized within cost accounting periods.

Contractors are precluded from withdrawing funds from pension plans to used for purposes that are not specifically sanctioned by the ERISA regulations. The idea of eliminating this floor would impose an inequitable financial imposition on contractors to fund these credits from resources outside of the pension, in effect double funding the same pension costs.

Modification of this floor should not be addressed by the board in the upcoming case. Settlement adjustments should only take place at the end of the contractual relationship between the Contractor and the Government or when a pension plan is terminated. Interim recognition of credits, would increase complexity and not change the need for a final settlement in the end.

We appreciate your consideration of our recommendations and welcome the opportunity to discuss any and all related matters. FEI staff and business leaders from FEI’s member companies are available to speak on any of these issues. If you or your staff should have any questions feel free to contact Mr. Robert Kramer at 202.626.7804.

Sincerely,



John Panetta, Chairman
 Financial Executives International
 Committee on Government Business



Deborah Tully, Chairman
 Financial Executives International
 Committee on Benefits Finance

¹ CAS 412-50(c)(2)(i) states: Any amount of pension cost measured for the period that is less than zero shall be assigned to future accounting periods as an assignable cost credit. The amount of pension cost assigned to the period shall be zero.

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SEP 04 2013

Mr. Raymond J.M. Wong
Office of Federal Procurement Policy
725 17th Street NW., Room 9013
Washington, DC 20503

Dear Mr. Wong,

The Defense Contract Management Agency (“DCMA”) wishes to take this opportunity to respond to the notice on *Cost Accounting Standards: CAS 413 Pension Adjustments for Extraordinary Events* published in the *Federal Register* on July 8, 2013.

DCMA has Cost Accounting Standards (“CAS”) administration responsibility for most contractors doing business with the Department of Defense. We have been in the forefront of overseeing implementation of the Adjustment provisions. It is from this perspective that the following comments are offered:

I. Complexity of Standard

The level of complexity relative to CAS pension expense has grown exponentially from the initial promulgation in the 1970s to the 1995 revisions and the CAS Pension Harmonization changes made in December 2011. To a large extent the changes to CAS 412 and CAS 413 are being driven by changes in pension accounting that are primarily focused on tax deductibility and Employee Retirement Income Security Act of 1974 (“ERISA”) funding. For example, for CAS purposes we now have to consider such funding requirements as Full Funding Limitations, Pension Protection Act, and Moving Ahead for Progress in the 21st Century (“MAP-21”) in the computation of CAS pension expense. Such considerations have increased the complexity of the CAS pension expense calculations, while not necessarily properly matching pension costs to cost objectives in the accounting periods in which pension benefits are earned.

The Adjustment has added another layer of complexity to CAS pension accounting. For example, the determination of whether an Adjustment is required, identification of affected contracts, and determination of the United States Government share of a pension asset’s surplus or deficit, are just several issues that increased the CAS 413 complexity. In the 8th July 2013 *Federal Register* promulgation, it appears that the CASB is focused on additional modifications to the CAS that could very well make the CAS even more complex.

II. Blank Sheet Approach

Rather than focus solely on the Adjustment process we would encourage the CASB to step back and assess the current environment of defined benefit pension plans and determine if there is a simpler methodology to measure pension expense for Government contracting purposes. More specifically:

- 1) Defined benefit pension plans are becoming more of the exception than the rule. A significant number of contractors that have existing defined benefit plans in place have already eliminated such benefits to new employees. The vast majority of contractors are offering their employees defined contribution/401(k) types of plans not defined benefit plans,
- 2) The complexity of the CAS 412 and CAS 413 calculations causes a significant delay between receiving the Contractor's pension expense forecast and confirming the validity of such; resulting in the inability to negotiate forward pricing rates on a timely basis. Since pension costs are typically such a significant component of forward pricing rates, most changes in the pension calculations have an inevitable impact on the forward pricing rates. This is especially true for defined benefits plans where it is difficult to predict long term costs as opposed to forecasting long term cost under defined contribution plans which are more predictable,
- 3) The intricacy of the CASB harmonization of the CAS with the Pension Protection Act has added yet another level of complexity to computation of CAS pension expense, and
- 4) Implementation of the CAS 413 Adjustment has caused significant allocation types of issues. For example:
 - a. There has been a noticeable uptick in Buyers of various companies and segments of companies refusing to accept defined benefit pension plans as part of the sales transaction. The Seller is left to maintain the pension plan assets and liabilities, even though the employees of the plan are transferred to the Buyer's organization, which leads to the issue of proper methodology in allocating future pension costs associated with these pension assets and liabilities that remain with the Seller.
 - b. Retirees have become a growing percentage of plan participants, due to defined benefit pension plan benefits no longer being offered to new hires. Accordingly, determination of the proper base to allocate inactive pension segment costs to active segment costs has become difficult to identify and a source for debate.
 - c. There have been significant litigations associated with measuring the segment closing adjustment; particularly as it pertains to determining the Government share.

Accordingly, in light of the aforementioned, we strongly suggest that the CASB analysis go beyond just the Adjustment process, by taking this opportunity to assess, whether a simpler

methodology can be developed to measure, assign, and allocate pension costs for Government Contracting purposes. This assessment could include whether a pension plan curtailment should trigger an Adjustment.

III. Elimination of Adjustment Associated with Pension Plan Curtailment

It is our opinion that curtailment of a qualified defined benefit pension plan that has not been formally terminated and the contractual relationship with the United States Government still exists does not require any Adjustment.

A qualified defined benefit plan may be amended formally to modify any benefits payable or provisions prospectively. For example, suppose a plan had provided a retirement benefit of 1 ½ percent of final average earnings for each year of credited service. If the plan is amended to reduce benefit to 1 percent of final average earnings for service after 1 January 2014 this does not trigger an Adjustment. In another example, an Adjustment is not required when the same plan is amended to change benefit structure to a Cash Balance form of accrual pattern for service after 1 January 2014. A plan amendment to not permit new entrants into the plan by any participant employed on or after 1 January 2014 would also not trigger an Adjustment. Therefore we question why there is an Adjustment required if the plan is amended to reduce benefit to zero percent of final average earnings for service after 1 January 2014. We believe there is no meaningful purpose to require an Adjustment in such a situation, since all of these illustrations would simply result in recognizing the ongoing CAS 412/413 Actuarial Valuations and annual cost determination in a similar manner.

Plainly, any plan amendment is recognized in the measurement of Actuarial Accrued Liability (“AAL”). The difference between AAL becomes an amortization element (of between 10 and 30 years) in the annual assignable CAS cost. Typically on a full curtailment the AAL is reduced creating an Actuarial Gain which results in lower annual cost. In addition, in the event of a full curtailment, the annual CAS normal cost is reduced to zero. Finally, in the normal CAS actuarial process, due to elimination of benefit accruals it is likely the plan will have an Assignable Cost Limit of zero resulting in no assignable CAS costs in the future. A provision for recognizing the gain or loss when the pension plan is actually terminated is still necessary.

IV. Triggering of Adjustments

In our opinion the following events would justify a CAS 413 closing adjustment:

1) Formal defined benefit plan termination.

The plan is terminated as of a specified date and all liabilities are settled either by lump sum payment or purchase of an annuity contract to individual participants. All obligations of the plan are settled and the pension trust is liquidated. Assets available must cover all liabilities for a Standard Termination to occur and requires cash contribution to cover any shortfall in assets. Any shortfall or surplus in plan assets over liabilities forms the basis of the CAS 413 settlement.

2) Completion of a USG Contractual Arrangement.

The contractual relationship between the Contractor and USG ends. Those participants remaining in defined benefit plans covered by CAS relationship that are now “orphaned” since contractual relationship no longer exists but pension plans does need to be settled since future CAS costs are not reimbursable.

3) Termination of a USG Contractual Arrangement.

A contract is terminated and there no longer exists any contractual relationship between the Contractor and USG. Those participants remaining in defined benefit plans covered by CAS relationship that are now “orphaned” since contractual relationship no longer exists but pension plans does need to be settled since future CAS costs are not reimbursable.

4) Sale of a Business unit or Segment.

A CAS segment or business unit is sold. However, the pension assets and liabilities of either the Inactive and/or Active participants remain with the Seller. These participants in defined benefit plans now are “orphaned” because certain pension plan participants (either Inactives and/or Actives) remain in the Seller’s pension plans, even though the employees and contracts are transferred to the Buyer.

V. Clarification of CAS 413-50(c)(9) Inactive Segments

The cost accounting treatment of the Inactive Segment needs to be clarified. Based on our understanding, the Inactive Segment is treated as a separate pension plan segment that measures annually CAS 412 and 413 costs, experiences its own gains and losses, and is allocated its own assets and liabilities.

The issues that require clarification include:

- 1) Is this Inactive Segment considered to be its own pension plan segment with its own measurement of CAS Assignable Cost Limit (“ACL”)? If so, would ACL of zero set Inactive Segment assignable cost to zero?


2) If this Inactive Segment is not defined as a separate pension plan segment with its own measurement of CAS 412/413 costs, would ACL only be determined for the entire plan (Active and Inactive) and costs be set to zero if entire plan ACL is zero? Could measured CAS 412/413 costs for an Inactive Segment be “negative” or a Credit? If so, based on either (1) or (2) above being applicable, would the entire plan CAS cost be the sum of all costs, both positive and negative?

VI. Summary

DCMA believes that the implementation of CAS 412 and CAS 413 is overly complex and difficult to administer. Instead of focusing just on the Adjustment process, we encourage the CASB to take this opportunity to assess the current environment/trend of defined benefit pension plans to determine whether a simpler methodology can be established for the measurement, assignment, and allocation of CAS covered pension costs. It is our opinion that such an assessment will find that the denial of defined benefit pension plans to new entrants, buyers refusing to accept pension assets and liabilities in conjunction of the purchases of segments, and the constant impact of ERISA changes on the CAS could lead the CASB to develop a CAS pension accounting that is less complicated and complex than that which currently exists. This simpler CAS should include elimination of pension plan curtailments from triggering an Adjustment if the contractor continues to perform Government contracts.

Should you require additional information of clarification, please contact Bill Romenius at William.Romenius@dcma.mil.

Sincerely,


Timothy P. Callahan
Executive Director
Contracts



September 5, 2013

Sent via e-mail to casb2@omb.eop.gov

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

Dear Sir or Madam,

Reference: Fact-finding—CAS 413 Pension Adjustments for Extraordinary Events

Aon Hewitt has prepared this letter in response to the request for public comments by the Cost Accounting Standards (CAS) Board as published in the *Federal Register* on July 8, 2013. We appreciate the opportunity to provide comments to the CAS Board as it develops its Staff Discussion Paper on CAS 413 Pension Adjustments for Extraordinary Events.

Who We Are

Aon Hewitt empowers organizations and individuals to secure a better future through innovative talent, retirement and health solutions. We design and execute, as well as advise on, a wide range of solutions that enable organizations to cultivate talent to drive organizational and personal performance and growth, navigate retirement risk while providing new levels of financial security, and redefine health solutions for greater choice, affordability, and wellness. Aon Hewitt is the global leader in human resource solutions, with over 30,000 professionals in 90 countries serving more than 20,000 clients worldwide. We offer actuarial consulting services to many of the largest government contractors in the U.S., including several of the top 20 Department of Defense contractors. For more information on Aon Hewitt, please visit www.aonhewitt.com.

General Comments

Many defense contractors are working hard to control costs and stay competitive in the current business and economic environment,¹ and the existing CAS 413 has been an obstacle to effective management of pension costs. Many Government contractors would like to eliminate future pension accruals but do not want to engage in lengthy litigation over a one-time CAS 413-50(c)(12) adjustment and/or go through a costly exercise to determine the Government's share of the adjustment. Amending CAS 413 to remove benefit curtailments from one-time adjustments would enable contractors to stay competitive and control cost and risk.

¹Defense contractors are not alone in this effort. According to Aon Hewitt research, close to 100 *Fortune 500* companies froze their primary salaried pension plan in the period from 2004 to 2012. Many factors contributed to this trend, but the pace of plan freezes increased after the enactment of the Pension Protection Act (PPA) in 2006.



Conversely, CAS 413 adjustments should be retained for plan terminations and segment closings. The finality of these events warrants a one-time true-up of plan costs, regardless of the ongoing contracting relationship.

The remainder of this letter will address specific issues raised in the CAS Board's request for comments published in the *Federal Register* and subsequent public meetings.

Benefit Curtailments

When the existing CAS 413 provisions were written in the 1970s and amended in 1995, benefit curtailments (i.e., full plan freezes) were relatively rare events. A plan freeze was likely a precursor to a full plan termination or subsequent corporate transaction, making it reasonable to treat benefit curtailments in the same manner as a plan termination or a segment closing.

In today's conditions, defined benefit plan freezes are becoming more common as contractors seek to reduce volatile costs of defined benefit plans and perhaps replace them with more stable defined contribution plan costs. This is a strategic business decision related to the delivery of retirement benefits which does not alter the ongoing Government contracting relationship.

In this situation, the contractor continues to perform Government contracts and it is unnecessary to determine a one-time adjustment due to this event. A benefit curtailment is nothing more than a negative plan amendment taken to the extreme, where the benefit formula is reduced to zero for future accruals.

We recommend that benefit curtailments be excluded from the one-time adjustment provisions. Instead, they should be treated as plan amendments in accordance with the contractor's disclosed cost accounting practice.

Plan Terminations and Segment Closings—Actuarial Assumptions

As noted above, CAS 413 adjustments should be retained for plan terminations and segment closings due to the finality of these events.

In general, the assumptions used to determine the plan liability under a CAS 413 adjustment should be consistent with the nature of the underlying event:

- For plan terminations, the current rule specifying that the "actuarial accrued liability shall be measured as the amount paid to irrevocably settle all benefit obligations or paid to the Pension Benefit Guarantee [sic] Corporation" should be retained. The amount paid to irrevocably settle the obligation is the best true measure of cost.
- For segment closings, CAS 413 should explicitly require the actuarial assumptions to be consistent with the expectations related to the event. For example, a closing or sale of a division may lead to accelerated retirements. Given the finality of the adjustment, the accelerated retirements should be reflected in the calculation of the segment liability for CAS 413 adjustment purposes.



In recognition of the objectives of harmonization and consistency with ongoing CAS 412 cost recognition, the minimum actuarial liability (as defined in CAS 412-50(b)(7)) should be the liability basis for determining the CAS 413 adjustment in segment closings. Ignoring periods with legislative or regulatory relief (e.g., the Moving Ahead for Progress in the 21st Century Act or “MAP-21”), the minimum actuarial liability most closely represents the liability on a current market value basis and using it would be consistent with the current requirement to use the market value of assets in the determination of the CAS 413 adjustment.

In addition, significant one-time plan termination adjustments can be reduced if an Assignable Cost Limitation buffer would be allowed under CAS 412-50(c)(2)(ii). The addition of a buffer would allow for a more systematic path to plan termination and avoid large cost disconnects that would be difficult to budget for. The addition of such a buffer would be consistent with the direction and spirit of PPA harmonization.

Other Settlement Events

In the current environment, there are many common settlement events that fall short of a full plan termination or segment closing. These events include in-plan or out-of-plan annuity purchases and lump sum windows that provide an opportunity for plan sponsors to reduce ongoing obligations and risk within their plan(s). It is not appropriate or necessary to include these types of events under CAS 413 adjustments. These types of events are part of the financing strategies of contractors/plan sponsors, and the current CAS 412 and 413 rules provide an appropriate framework for recognizing costs after the implementation of these events.

Plan Terminations and Segment Closings—Issues Related to CAS 413-50(c)(12)(iii)

The CAS Board needs to provide further guidance and/or examples for determining a segment closing date or plan termination date, particularly the circumstances that may result in inequitable calculations. In general, the plan termination date is the date upon which the last obligation is settled, but this concept should be memorialized in updated rules. For segment closings, bright-line tests and/or illustrative examples should be included to provide a better framework for negotiating segment closings.

Segment Closings—Issues Related to CAS 413-50(c)(12)(v)

In situations where only some of the pension plan assets and actuarial accrued liabilities of a closed segment are transferred to a successor contractor, Internal Revenue Code (IRC) section 414(l) rules are likely to cause a mismatch between the assets accumulated in the segment and the assets required to be transferred to the new contractor.

There are two situations to address, depending on whether the assets that are transferred under IRC section 414(l) are more or less than the assets being held in the segment under CAS 413 rules. Our view of how the transaction should be recognized is illustrated in the following two examples.

The illustrations pertain to a situation where a segment within a plan is closed due to the sale of a division by Contractor A to a successor contractor (Contractor B). The segment has \$100 in liabilities (\$100 of which will be transferred) and \$70 in assets accumulated in the segment.



Transferred Assets Exceed Segment Assets

In this example, \$75 in assets is required to be transferred to the new contractor. The situation is summarized in the following table:

	Prior to Sale	After Sale	
	Contractor A	Contractor A	Contractor B
Liabilities	\$100	\$0	\$100
Assets	\$70	\$(5)	\$75
Unfunded Liability	\$30	\$5	\$25

A CAS 413 adjustment of \$5 (a segment closing charge) is recognized at Contractor A, and the Government will be required to pay Contractor A \$5 (subject to the CAS 413-50(c)(12)(vii) fraction). The Government will benefit from the \$5 payment through reduced costs (reduced unfunded liability) at Contractor B. Presumably, Contractor B will retain the existing amortization schedule of the original unfunded liability from Contractor A. The \$5 adjustment required due to the IRC section 414(l) mismatch should be amortized over 10 years consistent with other actuarial gains/losses under harmonized CAS 412 rules.

Transferred Assets Are Less Than Segment Assets

In this example, \$65 in assets is required to be transferred to the new contractor. The situation is summarized in the following table:

	Prior to Sale	After Sale	
	Contractor A	Contractor A	Contractor B
Liabilities	\$100	\$0	\$100
Assets	\$70	\$5	\$65
Unfunded Liability	\$30	\$(5)	\$35

A CAS 413 adjustment of \$5 (a segment closing *credit*) is recognized at Contractor A, and Contractor A will be required to pay the Government \$5 (subject to the CAS 413-50(c)(12)(vii) fraction). Contractor A will benefit from the \$5 payment by retaining the \$5 in the plan. Presumably, Contractor B will retain the existing amortization schedule of the original unfunded liability from Contractor A. The \$5 adjustment required due to the IRC section 414(l) mismatch should be amortized over 10 years consistent with other actuarial gains/losses under harmonized CAS 412 rules.

Plan Terminations and Segment Closings—Issues Related to CAS 413-50(c)(12)(vi)

In many cases, contractors have long and complex histories in providing services to the Government. Mergers and acquisitions, segment combinations and splits, other changes in cost accounting, and incomplete or inadequate records can make determination of the Government's share of a CAS 413 adjustment expensive and time-consuming.



The current rule provides that the Government share can be determined using a fraction that is “representative of the Government’s participation in the pension plan.” While this rule is helpful in spirit, it does not provide enough guidance in determining what can or should be considered representative. To eliminate uncertainty, it would be helpful if safe harbor thresholds were specified. For example, pension plan costs determined over a period of at least 10 years would be considered representative if the contractor has had a consistent contracting relationship over that period (at least X% of sales derived from Government contracts throughout the period).

In addition, it would be helpful if an even simpler rule were put in place for *de minimis* adjustments. For example, if an adjustment represents less than X% of the sales derived from Government contracts, the fraction under CAS 413-50(c)(12)(vi) can be determined using current and/or prior year cost data instead of the full (or safe harbor) history.

Plan Terminations and Segment Closings—Issues Related to CAS 413-50(c)(12)(vii)

The CAS Board’s request for comments published in the *Federal Register* posed several questions about how adjustment debits (charges) or credits should be reflected in ongoing costs. Following is a summary of how we recommend the adjustments should be handled.

Generally speaking, any adjustment debit (*charge*) created under CAS 413 will require a one-time payment from the Government to the contractor equal to the Government’s share of the charge. In this case, the payment should be paid into the pension trust and credited to the segment assets. In cases where an amortization agreement can be negotiated, the contractor would set up an unfunded accrual (charge base) equal to the *gross* adjustment charge amount (prior to the application of the fraction determined under CAS 413-50(c)(12)(vi)). The charge base would be amortized over the agreed upon period.

Conversely, an adjustment *credit* under CAS 413 will require a one-time payment from the contractor to the Government equal to the Government’s share of the credit. Generally speaking, this payment will not (and cannot) be paid from the trust assets but will need to come from general contractor funds. From a plan perspective, the segment assets will be reduced by the gross amount of the CAS 413 adjustment and a prepayment credit will be created equal to the same gross amount. Costs will continue to be developed under the segment using the reduced assets and assigned to contracts, as appropriate. The prepayment credit will be available to cover those costs as they are recognized.

Working Group Question—What Is the Government’s Responsibility for Ongoing Costs?

The Working Group asked if the Government has an ongoing responsibility to reimburse pension costs in situations where events result in a plan segment that is no longer associated with current contract work or a plan segment that only has retired and vested terminated members remaining. These were referred to as “orphaned” segments.

The original intent of CAS 412 and 413 was to account for the cost of pensions as an allowable cost of doing business. Just as the cost of compensation paid to active employees was allowable, so was



the cost of deferred compensation to be paid to these same employees in the form of retirement benefits considered allowable. It is appropriate for the Government to honor this commitment and continue to reimburse the costs of pensions for these orphaned segments by including such costs in corporate overhead if they cannot otherwise be appropriately assigned.

A question was also raised about whether the Government should bear the risk of the contractor's investment decisions, specifically related to a plan sponsor's appetite for risky investments or lack of immunization through liability-driven investments. In our view, there has been a longstanding recognition that the Government has relied on the plan sponsor's role as a plan fiduciary to ensure that the plan's assets are invested prudently. This relationship has been in place for decades, and it remains effective today.

Closing

We want to express again our thanks to the CAS Board for taking on these important issues. This is a critical time for pension plan sponsors as they continue to address the overall economic, competitive, and human resource challenges of the 21st century. Government contractors are not immune to these challenges, and the changes and clarifications being discussed under CAS 413 will enable them to continue to meet the needs of the U.S. Government and national defense.

If you have any questions or comments, please contact the undersigned at the telephone number or email address provided below.

Sincerely,

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September 6, 2013

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

Reference: Fact finding – CAS adjustment for extraordinary events

Dear Mr. Wong:

We appreciate the opportunity the Cost Accounting Standards Board (CASB) has given us to provide these comments about CAS pension adjustments for extraordinary events, based on the notice issued in the Federal Register on July 8, 2013. We recognize the effort that the CASB is making by reaching out to interested parties in the notice and in the two fact finding meetings the CAS working group sponsored. We also appreciate Board's acknowledgement that for many plan sponsors, time is short. Many sponsors may be facing triggering events in the next few years, and a timely resolution of the concerns about CAS's current treatment of closing adjustments will facilitate mutually beneficial outcomes for both the government and its contractors.

The primary issues we would like to see addressed by the CASB are

- whether a benefit curtailment should trigger a closing adjustment,
- how to allocate pension costs when a plan has very few or no active participants earning a benefit, and
- how to measure the liability and closing adjustment when there is a triggering event such as a settlement or loss of a viable, on-going contract base.

Benefit curtailments and other triggering events

Under the current CAS, segment closings and benefit curtailments both trigger a segment closing adjustment. We believe that closing adjustments are an important way to "true-up" or finalize costs when the relationship between the contractor and the government is severed, such as when the contract base is gone and there are no more contracts. A true-up is also important when the plan is settled (usually as the result of a plan termination followed by lump sum payments and annuity purchases for the benefits), because there is no longer a plan. In both of those instances, there is no means of future cost recovery, and a closing adjustment is appropriate to achieve final equity between the government and the contractor.



However, we believe that a benefit curtailment should not trigger an adjustment. Simply curtailing benefits so that participants no longer earn additional benefits in the future does not alter the relationship between the contractor and the government. Nor does the plan dissolve, as it does when a plan is terminated and settled.

Under the current CAS, contractors are reluctant to curtail benefits because of the required adjustment, which is

- disruptive to pricing,
- difficult to determine, and
- leaves the contractor with a plan that will generate future gains and losses, but no clear guidance on whether or not costs created by those gains and losses will be reimbursable, and if they are reimbursable, how the costs will be allocated.



Instead, if curtailments are viewed as a plan change done in the course of on-going business, CAS cost determinations can continue unchanged, with one exception – cost allocation to the business segments.

Pension cost allocation after a curtailment

CAS413 presently provides a method of allocating costs for inactive employees as long as there are at least a few active employees participating in a plan. If a plan has an inactive segment, the costs associated with the inactive segment are allocated to the active segments using pay or headcount of the plan's active participants (413-50(c)(1) and (c)(9)). Such an approach could continue after a curtailment. There would continue to be active participants in the plan who could form the basis for a cost allocation. Those employees have existing plan benefits; they just aren't earning new benefits. Future costs will be the result of amortizing the existing costs and amortizing new gains and losses that arise. There will be no more normal cost (also called service cost).

The existing standard might want to clarify that the allocation base would not be limited to active employees who are earning new benefits, but instead active employees who have existing benefits as well. (The current standard is silent on the distinction in (c)(1), and a clarification could be made in (c)(1) or in an example.)

The standard might also want to address another issue that will likely arise under the current standard and will certainly arise if the standard is changed to remove benefit curtailments from the list of closing adjustment triggers: over time, due to natural attrition, whether or not a benefit curtailment has occurred, it is possible to see distortions in the cost allocation.

For instance, a plan has \$1,000,000 in costs in the inactive segment due to 1,000 retirees and only \$100,000 in costs due to 100 remaining active employees. If the retirees worked predominantly in segment A most of their careers, but the existing employees happen to work in segment B, then the segment A costs are being allocated to segment B. Such situations could be occurring at present under the current standards.

In the above example, and in cases where a curtailed plan's active headcount is low enough that the current allocation is no longer representative of where the costs were incurred, CAS413 could be amended to permit a broader allocation.



Measuring assets and liabilities in segment closings

The working group has posed several questions regarding the how the segment closing adjustment is measured.

It seems that when the time comes to sever the relationship between the government and the contractor (due to the plan going away or the absence of future contract business), the most equitable adjustment would be based on prevailing market conditions at the time of the event. There is no opportunity for smoothing future costs because there is no longer a relationship.

Based on that observation, we would recommend that the asset measurement remain at fair market value, as required in the current standard. We also agree that if the pension obligation is either annuitized or paid as a lump sum to participants (or a combination of the two), then the amount paid should represent the liability measurement.

In cases where the pension obligation remains with the contractor, the liability should be measured using a discount rate and other assumptions that best reflect the current market conditions. Using long-term assumptions will not result in an equitable cost true-up.

The participants in the fact finding meetings explored several possible discount rates based on a continuum from spot-rate to long term smoothing:

- 1) actual cash cost of annuitization and lump sum payments (works only if there is an actual plan termination and all liabilities are settled)
- 2) PBGC term rates (a surrogate for annuitization, but probably tends to overstate liability if contractor keeps the obligation and invests in assets that are not quite as conservative as those assumed by the PBGC)
- 3) Spot bond rate as of a term date or other method now described in CAS 412-50(b)(7)(ii)(A) (close to the GAAP requirements – can be volatile)
- 4) PPA 24 month average (some smoothing of discount rate, dependent on ERISA continuing to define and track the concept)
- 5) PPA with MAP-21 smoothing (even more smoothed than the 24 month average and also ERISA dependent)
- 6) Current long term rate of return (no correlation with actual value of the liability at the time of the closing adjustment)

An approach somewhere within options 3), 4) or 5) will likely yield an equitable result without the risk of too much volatility.

The current standard, with its unrealistically high discount rate, discourages contractors from curtailing or terminating plans. And when the contractors do so, there is strong financial incentive to annuitize so that then contractor will receive market-based reimbursement, even if annuitization proves very costly.

Effective Date of Final Rule

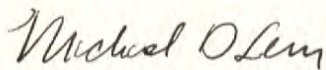
Because many contractors have closed their plans to new hires and because other plans are experiencing natural attrition due to other causes, contractors will soon be facing curtailments. Contractors may soon be facing benefit freezes on plans with non-union participants due to ERISA non-discrimination testing requirements.

Because contractors may be facing the above situation in just a year or two, revising CAS413 is extremely time sensitive. The sooner changes are made, the sooner the contractors can incorporate their impacts in their long term business strategy.

Conclusion

We appreciate this opportunity to provide the CAS board and its working group with our observations and suggestions. We look forward to future opportunities to provide additional information that may be useful for the Board's success in this challenging task.

Sincerely,



Michael Lem
Assistant Controller
The Boeing Company



Julie Curtis
Director of Actuarial Services
The Boeing Company



September 6, 2013

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Re: Fact finding – CAS adjustment for extraordinary events

We appreciate the Cost Accounting Standards Board's willingness to consider comments on and possible revisions to the current standard's method of determining pension cost adjustments when an extraordinary event occurs. We understand that due to the technical and complicated nature of the other changes that were already being introduced by the CAS Harmonization Rule, a decision was made to address segment closing adjustments under a separate project. Since the government contracting community is now operating under the Harmonization Rule, and the segment closing issue remains an open item that still needs to be addressed in order to complete the Harmonization mandated by the Pension Protection Act, we would like to offer our thoughts and suggestions on how to change segment closing calculations to fit the theme of Harmonization. We are offering these thoughts as actuaries and pension specialists who practice in the defense industry rather than acting as agents of our employers, so this paper may, or may not, represent the views of our employers.

Under the current Harmonized CAS there are two issues related to segment closings. One issue is the calculation of the liability that is included in the amount of the segment closing adjustment, and the other issue is the specific events that trigger a segment closing adjustment.

Regarding the pension liability that is reflected in a segment closing calculation, in the absence of a plan termination, the regulations presently require the calculation to be made using the actuarial accrued liability based on the accrued benefit cost method (AAL). The AAL is based upon long-term actuarial

assumptions. As explained further below, we believe that the resulting calculation is theoretically unsound and can be unfair to either party depending upon the prevailing interest rates at the time of the closing. Before explaining why, however, some additional background may be useful. The CAS currently provides for two measures of assets and two measures of liabilities. The various asset and liability measurements have different purposes:

- Smoothed measurements enhance predictability. Because the AAL “shall reflect long-term trends so as to avoid distortions caused by short-term fluctuations” (see CAS 412-50(b)(4)), AALs tend to be relatively stable. Similarly, the actuarial value of assets (“AVA”; see CAS 412-30(a)(15)) typically smoothes fluctuations in the market value and hence is relatively stable. Because of this smoothing effect neither the AAL nor the AVA provide an accurate snapshot of a plan’s funded status at any given point in time (i.e., segment closing).
- Unsmoothed measurements provide accurate point in time valuations. The market value of assets (“MVA”; see id.), by its very nature, precisely measures assets at a point in time. Similarly, the minimum actuarial liability (“MAL”), as defined in CAS 412-50(b)(7)(ii)(A), is based upon the “rates at which the pension benefits could effectively be settled based on the current period rates of return on investment grade fixed-income investments,” and is therefore a point-in-time measurement. Because these measurements capture the prevailing economic environment at a given point in time, the MVA and the MAL provide the most accurate measure of a plan’s funded status at that point in time.

The CAS currently compares the unsmoothed MVA against the smoothed AAL to determine the segment closing adjustment (i.e., the difference between the two amounts). This difference can fluctuate greatly and consequently reward one party while penalizing the other in an arbitrary manner. It also seems counterintuitive to use settlement assumptions during the going-concern phase of a segment while going-concern assumptions are used in the settlement calculation made in connection with a segment closing. Contrary to the wishes of Congress, we note that CAS 413 puts contractors in a position where the only way to achieve true “harmonization” upon plan curtailment is to fully terminate and annuitize the pension plan (in the case of a plan termination liabilities are measured by the cost of annuities which are more comparable to the MAL than the AAL). The current CAS effectively penalizes contractors who do not terminate

their plans and choose to retain responsibility for plan assets and liabilities when a curtailment occurs.

It is equally important to recognize that the current treatment effectively prevents harmonization. Coincident with directing the harmonization of CAS with the Pension Protection Act (PPA), Congress established the “funding target” (“FT”) as the optimal level of pension funding. Because the FT and the MAL are similar at segment closing, the PPA essentially contemplates that assets equal to the MAL would have been accumulated at the segment closing. By basing the segment closing on the AAL rather than the MAL, however, the current CAS effectively reverses harmonization on a cumulative basis. This means that any increases in CAS pension cost recovery that resulted from harmonization would need to be refunded to the Government at the time of segment closing. The net result is that the CAS Harmonization rule would be reduced to a temporary provision, initially resulting in contract cost increases to better align with the PPA but later reversing those increases when a segment closing is triggered. In effect, one Government agency would penalize a contractor if its pension assets are below the MAL while another would demand a refund of any excess of the MAL over the AAL. This conflicting result could be remedied by changing the segment closing calculation.

Clearly the current segment closing provisions do not achieve harmonization. As previously mentioned, because CAS 413 provides that annuity purchase prices are used to measure liabilities in the event of a plan termination, but not in the case of a segment closing or curtailment, the segment closing provisions will likely encourage contractors to terminate their pension plans in connection with segment closings or curtailments. We further note that encouraging contractors to exit the defined benefit system by terminating their pension plans as a means of avoiding the potentially devastating segment closing adjustments would, under the current CAS and established case law, create substantial Governmental obligations. In our view, the CAS Board should calculate segment closing adjustments based on the difference between the MVA and the MAL, where the MAL would be based upon the most recent set of interest rates that are available as of the segment closing date, as well as the Contractor’s disclosed practices.¹ This would ensure that both assets and liabilities used for segment closing

¹ In order to ensure that assets and liabilities reflect the same underlying economic conditions, we would suggest that spot interest rates (as opposed to a rates averaged over a period of time) be used in determining the liability for the segment closing calculation regardless of the rates used for ongoing MAL purposes.

purposes reflect consistent, market-based assessments of the prevailing economic conditions. The segment closing measure would be less volatile than in the current CAS and the potentially wide-reaching problems resulting from “deharmonization” at segment closing would be eliminated.

Turning to the second issue, we also believe there should be a change to the named events which trigger a segment closing calculation. In particular, a curtailment of benefits should not be considered an event that would result in a segment closing calculation or a segment closing adjustment. In cases where a segment is not closed and the pension plan is not terminated, and there is continuing performance on Government contracts, a curtailment of benefits should not result in a segment closing calculation. In such cases a segment closing adjustment would only result in an unnecessary obligation that would be levied against either the Government or the contractor, which would probably not serve the interests of either party. Since there will continue to be ongoing pension cost adjustments due to actuarial gains and losses in cost accounting periods subsequent to the curtailment, it would be much more practical to reflect any unfunded (or overfunded) liabilities at the time of curtailment in any pension costs subsequent to the curtailment. Continuing performance on Government contracts would readily lend itself to this remedy.

If this change is not made, it might incent pension plan sponsors to terminate a pension plan after a benefit curtailment, which could result in a significant liability for the Government. That might be the only way for sponsors who are forced to perform a segment closing calculation to have the amount determined based on prevailing settlement costs. This seems like an undesirable and unintended consequence that could be avoided by making this change.

We recognize that if curtailments are no longer considered a trigger for a closing adjustment, the issue of ensuring equitable cost allocations should be addressed. Under the current standard, allocations are based on the pay or headcount of active participants. At least for the first few years after a curtailment due to a benefit freeze, there will likely be a sufficient number of active employees who are also plan participants to permit a reasonable pay- or headcount-based allocation. Eventually, the number of active employees participating in the plan will decline enough that a pay- or headcount-based allocation no longer works. When that happens, an alternative method might be preferable.

We would like to thank you for your consideration of this very important topic. Since we are not representing any formal organization or any particular company we are providing our individual contact information below.

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September 6, 2013

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

This provision of CAS 413 states (emphasis added):

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

This provision states the following:

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

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

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

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

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

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

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

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

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

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

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

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

Before

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

After

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

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

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

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

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

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

General Questions

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

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

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

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

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

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

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

This allocation method will require the following steps each year:

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

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

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

Other cost allocation issues that need clarification are as follows:

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

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

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

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

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

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

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

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

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

Determining Segment Assets

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

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

Settlement of Inactive Liabilities

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

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

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

In Closing

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

Sincerely,



Gene H. Wickes
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Cost Accounting Standards Board
c/o Mr. Raymond Wong
Office of Federal Procurement Policy
725 17th Street NW -- Room 9013
Washington, DC 20503

September 6, 2013

Subject: Comments on CAS 413 Pension Adjustments for Extraordinary Events

Dear Mr. Wong:

We would like to thank the Cost Accounting Standards Board and its staff for the opportunity to comment during the public meetings in July and August on the potential changes being considered for the CAS 413 pension adjustments for extraordinary events. The comments expressed in this letter reiterate many of our verbal comments during the meetings, and raise a few additional items for the CAS Board's consideration. The comments expressed in this letter represent the views of the undersigned actuaries who work frequently with clients that are subject to the CAS pension accounting rules. It is important to note that our views are not necessarily the same as those of our clients or our firm.

Following is a summary of those issues that we feel would warrant further review and consideration related to this topic:

Curtailments

We believe that the curtailment of benefits should be excluded from the list of events that give rise to a segment closing adjustment. A plan freeze is a different type of event than the sale of a segment or the termination of a pension plan. In particular, when a plan is frozen, assuming there is no change in the relationship between the contractor and the government, there is simply a reduction of the amount of future benefits that are accruing under the DB pension formula. As such, we believe that it would be more appropriate to treat benefit curtailments like plan amendments, which would be amortized into future cost accounting periods, and for the contractor to continue calculating assignable pension costs under CAS 412/413.

It should be noted that there are a number of plan freezes that either have, or will have occurred prior to any potential changes to CAS 413, and will still be subject to the existing CAS 413 rules.



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Merging or Eliminating Segments and Use of Inactive Segments

We recommend that CAS 413 be amended to give contractors more flexibility to combine or eliminate segments due to corporate restructuring actions where legacy pension segments no longer make sense. This could help alleviate the problem that some contractors are beginning to face of “orphaned” segments, where a soft freeze occurred some years ago, and the number of active participants in a given segment is diminishing, and costs for that segment are being allocated over a smaller base.

Related to this, we feel that the inactive segment concept which is allowed under CAS 413 is an excellent solution to the “orphaned” segment problem, however, in practice it is difficult to implement. Allowing more flexibility for contractors to set up and maintain an inactive segment would be a positive change to the CAS.

Pension Plan Mergers and Spin-Offs

When a pension plan is merged or a plan is spun into multiple plans, the ERISA rules and/or the purchase and sale agreement usually dictate the amount of assets to be transferred. These assets are often not equal to the CAS assets associated with the affected liabilities being transferred. When this is the case, a balancing item must be created to maintain the CAS balance equation. In these cases, we would suggest that any excess transfer amount be considered a prepayment credit, and in the case of a shortfall, such amount be treated as an unallowable expense.

Example 1: Assume Plan A has three segments: A1, A2 and A3, and is transferring assets and liabilities for Segment A1 to Plan B. Prior to the transfer, the assets of Plan A equal \$1,000,000, consisting of \$400,000 for Segment A1, \$400,000 for Segment A2, \$100,000 for Segment A3 and \$100,000 in prepayment credits. Based on the required transfer amounts which are predicated by the purchase and sale agreement, Plan A must transfer \$475,000 related to the liabilities of Segment A1 to Plan B. In order for the CAS balance equation to be maintained, Plan A should transfer \$400,000 of CAS assets and \$75,000 of the existing prepayment credit to Plan B.

Example 2: The facts are the same as Example 1, however the required transfer amount predicated by the purchase and sale agreement is \$525,000 related to the liabilities of Segment A1 that are spinning off to Plan B. In order for the CAS balance equation to be maintained, Plan A should transfer \$400,000 of CAS assets, and \$125,000 the remaining plan assets to Plan B. Since the excess of the transfer amount is greater than the existing prepayment credit, then Plan A should set up an unallowable amount of \$25,000 which should be allocated to the remaining segments in proportion to the CAS assets for the remaining segments. As such, \$20,000 of the unallowable amount should be allocated to Segment A2 (so the sum of the remaining assets, plus the unallowable amount remains \$400,000) and \$5,000 of the unallowable amount is allocated to Segment A3 (so the sum of the remaining assets, plus the unallowable amount remains \$100,000).



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Participant Transfers Between Segments

When participants transfer among segments, we believe that the appropriate liability basis for determining the amount of required asset transfer should be based on the harmonized liabilities. That is, the liability should be equal to the MAL as of the actuarial valuation date first occurring on/after the participant transfers between segments. While a strong supporting argument can be made for using the same spot basis (for those plans that employ a smoothing bases for the MAL discount rate) as we recommend below related to segment closing adjustments, we don't believe that the incremental precision warrants the additional calculations in the case of transfers among segments.

Assignable Cost Limit – Adding a Buffer

It is well understood that any mark to market accounting basis will be inherently more volatile than a smoothed basis. The CAS Board recognized that dilemma in developing the harmonization rules, choosing to employ longer amortization periods that permitted for ERISA minimum funding purposes. Given the CAS Board's desire to have CAS expense be more stable across multiple years, we believe it makes sense to provide for a buffer on the Assignable Cost Limit calculation.

While in most cases the CAS expense for a plan or segment hitting the assignable cost limit will be fairly low (or even zero) prior to the application of the assignable cost limit, timing differences could result in situations where the expense is limited by the assignable cost limit well before all existing amortization bases are extinguished. In that case, any subsequent actuarial loss will be amortized over 10 years, which may be a shorter time period than the weighted average period for the existing amortization bases. Should this occur, the CAS expense may be even more volatile than the market performance should suggest.

To alleviate this concern, we would suggest that the liability for the assignable cost measure be increased to 115% of the otherwise applicable liability. In our opinion, this 15% buffer provides a reasonable cushion to absorb future volatility. Also, settling plan liabilities through the purchase of annuities often results in costs that are 10-20% above the mark-to-market liabilities.

It is important to note that absent any new gains/losses occurring, the excess above the 100% amount will be amortized as a gain over a 10-year period starting on the next valuation date, since the ongoing CAS expense calculations will remain calibrated to achieve 100% funding. So while the current year CAS expense will be higher than if no buffer were utilized, the expense will be far smoother and any "excess CAS expense" due to the buffer will serve to reduce future years' CAS expense over a 10-year period.



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Actuarial Basis for the segment closing liability

When a segment closing adjustment occurs, there is a comparison between the actuarial liability and the market value of assets. Just as the assets are valued at market value for purposes of this calculation, we also believe that the liabilities should reflect a fair market value. As such, we would suggest that the segment closing adjustment calculations be modified to reflect spot interest rates as of the date of the segment closing. The basis for these calculations could be the same basis as used by the contractor to determine their Minimum Accrued Liability/Minimum Normal Cost (MAL/MNC) calculations, but without reflecting any interest rate averaging or smoothing that is permitted for purposes of determining the ongoing CAS expense (i.e., calculated on a "spot" interest rate basis). If the CAS Board would prefer to use a single set of interest rates for all contractors, we would suggest that the Board consider using the PPA spot segment interest rates that are published monthly by the Treasury (the spot rates for each segment are published each month along with the 24-month average segment rates that are used for minimum funding calculations).

We also believe that the segment closing liabilities should reflect the present value of future administrative expenses. This is important as the MNC calculation for an ongoing plan includes a provision for the current year administrative expenses, so including a provision for the present value of future administrative expenses seems appropriate when performing the segment closing calculations due to the final nature of these calculations.

We note that the current language in CAS 413 allows the cost of purchasing annuities and/or paying lump sums to be used in cases where the liabilities are settled in this fashion in connection with a segment closing. We believe that this provision should be retained so that contractors experiencing a segment closing can effectively settle their pension liabilities without incurring additional costs.

Lastly, in considering changes to the definition of the segment closing liability, we would request that the CAS Board clarify that the remaining actuarial assumptions to be used be appropriate for the closed segment. In particular, the reference to "current and prior" actuarial assumptions has led to discussions with DCAA in some circumstances, often in situations where the prior assumptions were changed well in advance of the segment closing taking place since they no longer represented the contractor's best assumptions as to future events. We believe that a more refined definition of the actuarial assumptions to be used would be "current and reasonable assumptions that are appropriate to the closed segment".

Asset allocation issues / lack of historical allocation data

The current CAS rules set forth what appears to be a relatively straight-forward methodology for determining segment closing adjustments. In principle, the rules endeavor to base the segment closing adjustments on the full historical cost basis for the affected segment. In practice, however, this principles are difficult to apply.



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In many situations in which segment closings occur, it is not possible to obtain or recreate the historical information for the segments. While the CAS regulations allow the contractor and the contracting officer to agree on a mutually agreeable method for estimating the history, our experience is that has led to disagreements in the past.

In particular, the asset allocations for plans using composite accounting should be allowed to be performed using the accrued liability proration method defined in CAS 412-50(c)(5)(ii) as a safe harbor. This makes logical sense since the plan is being accounted for on a composite basis, and thus CAS pension costs are being allocated on a uniform basis across multiple segments. In light of the CAS Harmonization rules, we believe that the language covering the allocation of assets to the segment should be clarified to reflect the ongoing CAS liability at the time of the segment closing on a harmonized basis (i.e., the greater of the MAL or long-term basis).

Phase-in of plan amendments

The current 60-month phase-in for plan amendments parallels the PBGC's phase-in methodology for plan terminations. We believe that this phase-in makes sense where there are material, voluntary plan amendments shortly before segment closing. That said, we don't believe that the phase-in should apply to more "routine" plan amendments, such as reflecting legislative increases that automatically occur under the existing terms of the plan, or in the cases where routine plan amendments don't increase plan costs by a set percentage (e.g., 5%).

We welcome the opportunity to submit our comments for the CAS Board's consideration and would be happy to answer any follow-up questions that you may have.

Sincerely,

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