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Mr. Eric Shipley
Project Director
Cost Accounting Standard Board
Office of Management and Budget
725 17th Street, NW
Room 9001
Washington, D.C. 20503

Via: E-Mail and FAX to 202-395-5105

Re: CAS Pension Harmonization ANPRM – Public Comment (50 *Fed. Reg.* 51261, Sept 2, 2008)

Dear Mr. Shipley:

Thank you the opportunity to comment on the Advanced Notice of Proposed Rulemaking (ANPRM) addressing the "Harmonization of Cost Accounting Standards 412 and 413 with the Pension Protection Act of 2006." 73 *Fed. Reg.* 51261, September 2, 2008.

By way of background, these comments represent my own views as an Adjunct Professor of Government Contract Law at the University of Baltimore School of Law, and as the former Executive Secretary and Counsel of the Cost Accounting Standards (CAS) Board (1991– 2005). They should not be construed as representing the views of any agency of the U.S. Government. I am also authorized to state that these views represent those of Rein Abel, PhD, formerly Director of Research of the CAS Board (1991 - 2005) and former Professor of Accounting at the Wharton School of Business at the University of Pennsylvania.

Because the proposed rule is contains many technical and actuarial provisions, I am concerned that the basic purpose of CAS, which differs from those of other accounting standards and rules, may be lost in the details.

In the CAS Board Statement of Objectives, Policies, and Concepts – May 1992, 57 *Fed. Reg.* 31036, July 13, 1992, the Board discusses the CAS in "Relationship to Other Authoritative Bodies."

> A number of authoritative bodies have been established to issue pronouncements affecting accounting and financial reporting. The Cost Accounting Standards Board views its work as relating directly to the preparation, use, and review of cost accounting data in the negotiation, administration, and settlement of Government contracts. ...
>
> The accounting areas of interest to the Board that are also of interest to others for financial and tax accounting purposes are: (1) definition and measurement of costs; (2) assignment of the cost of resources consumed to time periods; and (3) allocation of direct labor, direct material, and indirect costs to the goods and services produced in a period.
>
> The Cost Accounting Standards Board seeks to avoid conflict or disagreement with other bodies having similar responsibilities and will, through continuous liaison, make every reasonable effort to do so. The Board will give careful consideration to the pronouncements affecting financial and tax reporting and, in the development of Cost Accounting Standards, it will take those pronouncements into account to the extent it can do so in accomplishing its objectives. The nature of the Board's authority and its mission, however, is such that it must retain and exercise full responsibility for meeting its objectives.

In the current ANPRM, the Board discussed the distinctly different purposes of the CAS, the Employees' Retirement Income Security Act (ERISA) and generally accepted accounting principles (GAAP) by stating:

> The Board believes that the measurement and assignment of pension cost will continue to be based on reasonable, long-term assumptions. Unlike the CAS, the purposes of the PPA minimum required funding and generally accepted accounting principles (GAAP) expense disclosures are unconcerned with cost predictability and stability across periods. The PPA is concerned that plan assets can adequately liquidate the settlement liability under current market conditions. GAAP is concerned with reporting the results of corporate operations during the current period, including changes due to market conditions. CAS 412 and 413 are concerned with (i) assigning pension costs to periods that reflect the going-concern nature of the contractor and pension plan, (ii) the long-term pension funding and investment decisions of the contractor sponsoring the plan, and (iii) minimizing volatility to enhance predictability for forward pricing.

The CAS has been, and I agree the CAS should continue to be, concerned with predictably (minimal volatility) across cost accounting periods to support the estimating, accumulating and reporting of costs for flexibly and fixed price contracts. Fair value accounting of the liability (also called "mark-to-market" accounting) may be appropriate for financial disclosure purposes

under GAAP, but is inappropriate and disruptive of the contract costing function. Likewise, ERISA's mandates and limits for current period funding are inappropriate for cost predictability and stability across periods.

I fully support the following goals for pension harmonization as stated in the paragraph entitled **1) Harmonization Goals** of the Board's ANPRM:

> b) No direct adoption of the Employee Retirement Income Security Act of 1974, (ERISA) as amended by the Pension Protection Act (PPA), to avoid any change to contract cost accounting without prior CAS Board approval since it is quite likely that Congress will amend ERISA in the future.
>
> c) Preserve matching of costs with causal/beneficial activities over the long-term.
>
> e) Mitigate volatility (enhance predictably).

I concur with the Board's response under "# 8, "Going Concern" versus "Settlement" Measurement of the Liability," in which the Board states:

> The Board continues to believe that for contracting costing purposes, pension costs must be based on "going concern" measurement and assignment methods and criteria. CAS 412 and 413 will continue to require measurement of the actuarial accrued liability and normal cost using long-term, "best-estimate" actuarial assumptions and recognize projected benefit levels. ***Such measurements diminish cost volatility between periods, enhance predictability for forward pricing and provide a better matching of costs with activities over extended periods.*** ***(Emphasis added.)***

I was pleased that the Board reiterated the importance of the distinctions between the various accounting rules in the response to "#8a - Basis for Measurement - Interest Assumption," writing:

> The Board believes that the measurement and assignment of pension cost will continue to be based on reasonable, long-term assumptions. Unlike the CAS, the purposes of the PPA minimum required funding and generally accepted accounting principles (GAAP) expense disclosures are unconcerned with cost predictability and stability across periods. The PPA is concerned that plan assets can adequately liquidate the settlement liability under current market conditions. GAAP is concerned with reporting the results of corporate operations during the current period, including changes due to market conditions. CAS 412 and 413 are concerned with (i) assigning pension costs to periods that reflect the going-concern nature of the contractor and pension plan, (ii) the long-term pension funding and investment decisions of the contractor sponsoring the plan, and (iii) minimizing volatility to enhance predictability for forward pricing.

> While the receipt of future Government contracts is not guaranteed, generally, companies subject to CAS 412 and 413 through full CAS-coverage or through FAR 31.205-6(j) have a contractual relationship with the Government that spans many years, or even decades. ***It is inappropriate for and disruptive to the contract pricing process to introduce cost fluctuations due to changing market conditions.*** Instead, the appropriate measurement and assignment of pension cost should reflect the best-estimates of long-term investment returns. As for recognition of future investment gains, the CAS generally require that gains or other credits be recognized when reasonably foreseeable. ***(Emphasis added.)***

I applaud the Board for looking beyond mere coordination with the ERISA minimum required contribution and consideration of the effect of salary projections on the stability of costs across periods. Under #8b – Salary Projections" the Board states:

> "The Board believes that the measurement of the actuarial accrued liability and normal cost should continue to permit recognition of expected future salary increases. Such recognition is consistent with a long-term, going-concern basis for the liability measurement. Since the benefit increases attributable to the salary increases are part of the long-term cost of the pension plan, including a salary increase assumption helps to ensure that the assigned cost adequately funds the long-term liability. ***Anticipating future salary growth may also avoid sharp pension cost increases as the average age of the plan population increases with the march of the "baby-boomers" towards retirement.***" (***Emphasis added.)***

The impact of the ERISA full funding limitation and more recently the CAS 412 Assignable Cost Limitation have presented long-standing predictability problems for forward pricing. I am pleased the Board is addressing this problem, which has always been a predictability problem. This problem was first addressed in the Staff Discussion Paper (SDP) entitled "Fully Funded Pension Plans." 56 *Fed. Reg.* 41151, August 19, 1991. In that Paper, the staff wrote:

> Government contract policymakers also have their own set of special needs, some involving the rhythms peculiar to the pricing of Government contracts, and others involving matters of public policy. It seems obvious, that in the pension area, aggregate pension costs included in prices must reasonably and accurately track accruals for pension costs on the books for Government contract costing purposes. In other words, booked pension costs need to be sufficiently predictable so that forward pricing rates for fixed price contracts are not based upon pension cost levels different from those ultimately accrued for the period of contract performance. ***That has not been happening in many instances when a fully funded status has been reached unexpectedly.*** Thus, in a number of instances, where estimated pension costs used for negotiating fixed price contracts include a significant element of pension cost, the subsequent achievement of full funding status served to eliminate pension costs altogether for the period of contract performance. (***Emphasis added.)***

Harmonization is not a new subject to the CAS Board. Even in the early 1990s the matching of ERISA funding and contract cost accruals was of concern to the staff. The SDP continues:

> The costing and pricing of Government contracts also requires a systematic scheme for accruing pension cost that precludes the arbitrary assignment of costs to one fiscal period rather than another to gain a pricing advantage. The Government also has sensitivity to the inclusion of unfunded pension costs in contract prices. Conversely, the staff's research revealed one instance of a contractor who, due to the shortened amortization periods now contained in the Tax Code, faced minimum ERISA funding requirements in excess of the CAS 412 pension cost and, thus could not be reimbursed. That particular contractor felt, understandably, that allowability ought to be tied to funding under the Tax Code. ***Obviously, given the current tax law climate regarding full funding, complete realization of all of these goals is not achievable. In the staff's opinion, the goals of predictable and systematic accrual outrank that of funding.*** However, funding still remains an important consideration. (***Emphasis added.)***

Based on the present ANPRM, the effect of predictability, or the lack thereof, on forward pricing remains a concern to the Board. In response to "#11 Assignable Cost Limitation," the Board explains:

> The Board has reviewed the effect of the assignable cost limitation on cost assignment, especially the effect on predictability. ***Government agencies and contractors have both found that the abrupt and substantive change in pension cost as a plan goes above or below the current assignable cost limitation gives an unintended windfall to one party or another with respect to fixed price contracts. These abrupt and substantive changes also wreak havoc on program budgeting for flexibly-priced contracts.*** Currently, once assets equal or exceed the actuarial accrued liability and normal cost, the pension costs drop to zero and the Government's recovery of the surplus can be indefinitely delayed. When assets are lower than the liability and normal cost, the reverse occurs and the contract may never be able to recover substantial incurred pension costs that were never priced. (***Emphasis added.)***

I urge the Board to continue its efforts to maintain or improve contract cost predictability and reject any impulse to match-up ERISA funding with contract cost accrual. Reconciliation of the ERSIA required minimum funding with contract cost accruals must give serious consideration to the "rhythms peculiar to the pricing of Government contracts."

While I am opposed to a fair value accounting as an accounting basis for the CAS, I also agree with the Board's proposal to subject the liability measurement to a settlement liability minimum.

I agree with this approach primarily because recognizing such a minimum liability measurement will not only achieve harmonization, but will better align the liability measured for period costing with the liability basis for segment closing adjustments and thereby increase predictability. I concur with the Board's response which states:

> That said the Board views the PPA funding target, as well as the FAS 87 accumulated benefit obligation, as approximations of the current market-related settlement liability for benefits, ignoring the administrative expenses associated with actual settlements. While the Board believes that the existing long-term, "going concern" measurement basis of the

CAS provides full and adequate funding of the pension liability over the long haul, it would be imprudent not to consider adequate funding of the current settlement liability. The Board notes that the recognition of minimum pension obligation as a liability is mentioned in FAS 87 and as long ago as Accounting Research Bulletin No. 47, *Accounting for Costs of Pension Plans,* published in 1956. Accounting Principles Board (APB) Opinion 8, *Accounting for the Cost of Pension Plans*, which was used as the basis for original CAS 412 and 413 required that "if the company has a legal obligation for pension cost in excess of amounts paid or accrued, the excess should be shown in the balance sheet as both a liability and a deferred charge."

Accordingly, the draft rule being proposed today begins to recognize a minimum actuarial liability based on benefits accrued to date and current settlement rates of corporate bonds of durations that match the expected benefit payouts. The Board believes that the liability measured by the PPA funding target will comply with the proposed definition of the minimum actuarial liability. The draft proposed rule also recognizes a minimum normal cost measured on the same basis. By adding this floor to the liability and normal cost basis, the Board expects that harmonization of the assigned cost with minimum required contributions will be improved. Furthermore, ensuring that assigned costs during the course of Government contracting will adequately fund the settlement liability should minimize the risk of large deficits when a segment closing or plan termination occurs.

In conclusion, I recommend that the CAS Board consider revisiting the Board's Statement of Objectives, Policies and Concepts. Part of any such review should include a reaffirmation of predictability as a specific goal or objective of CAS.

Thank you for your consideration of these comments.

Sincerely,

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