07 CMS Actuaries
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Submitted Electronically

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

RE: CAS Pension Harmonization ANPRM

We welcome this opportunity to comment on the Advance Notice of Proposed Rulemaking on Harmonization of Cost Accounting Standards (CAS) 412 and 413 with the Pension Protection Act (PPA).

As pension actuaries for the Centers for Medicare & Medicaid Services (CMS), our primary responsibility is to provide technical and actuarial support to the Office of Inspector General (OIG) auditors who review pension costs claimed by CMS. We also assist our agency in resolving contract claim disputes and serve in an advisory capacity on other issues related to retirement plans and employee benefits. Prior to joining CMS, we were employed as consulting actuaries and worked extensively with private employers on matters pertaining to compliance, plan administration, actuarial funding, and financial accounting for employee benefits. Our comments represent our personal views and not necessarily those of our employer or of any other agency of the Federal government.

The proposed rule relies on the same fundamental approach for measuring pension liabilities that has been in effect since the CAS pension rules were first adopted in 1975. The CAS allows a contractor to choose between several actuarial cost methods and requires that the discount rate represent the expected long-term rate of return on plan assets. Although the CAS measurement basis was once consistent with the methods and assumptions in common use, this is no longer the case. In 1985, the Financial Accounting Standards (FAS) were modified to require that pension costs for financial reporting purposes be calculated using the projected unit credit (PUC) cost method and a discount rate that reflects the rates of return currently available on high-quality corporate bonds of appropriate duration. In 2006, the Employee Retirement Income Security Act (ERISA) was amended by the PPA to require the use of durational discount rates that are determined in a manner consistent with the FAS. The PPA also requires all plans to use the unit credit cost method (PUC without projection) to determine minimum funding, and the PUC method to determine the maximum tax deductible contribution.

We recognize that the objectives of the CAS differ from those applicable for other purposes and agree that these differences should be taken into consideration. We are also sympathetic to the Board's desire to keep changes to a minimum. However, we do not believe that the objectives of the CAS are best served by retaining a measurement basis that is no longer utilized for ERISA or financial reporting. In fact, we doubt that this approach would be considered a viable option under the present circumstances, if not for that fact that it is already in effect. We view this as a critical flaw in the proposed rule, and we urge the Board to reconsider this important issue before proceeding with the promulgation process.

The following outlines the reasons for our objection to the measurement basis under the proposed rule and offers an alternative for the Board's consideration. Also included are comments and recommendations relating to a number of other aspects of the proposed rule.

Measurement Basis

In 1992, the CASB released a *Statement of Objectives, Policies, and Concepts,* which cites two primary goals for cost accounting standards: (i) consistency between contractors, and (ii) consistency over time for an individual contractor. It also sets forth other important criteria to be taken into consideration. Verifiability is described as a key goal for any cost accounting standard, as is a reasonable balance between a standard's costs and benefits. We believe that the liability measurement basis under the proposed rule severely conflicts with these goals.

The pension liabilities used to develop contract costs must be verifiable. If the data used for contract costs are not reconcilable with the data used for other reporting purposes, the information will be open to bias and manipulation.

Similarly, if the pension liabilities determined in accordance with the CAS are inconsistent with those used for other purposes, there will be no alternative source from which to obtain this information. We have encountered many situations in which a contractor was not aware of the requirement to compute a special cost for contract reimbursement or did not maintain the CAS information required for audit or segment closing calculation. In these cases, ERISA reports or financial statements were used to obtain the necessary liability information, and the CAS computations could be reconstructed. The data required under the proposed rule are obsolete for other reporting purposes and will not be available if the calculations required under the CAS are not performed, or if the documentation is not retained. It will be difficult or impossible to develop reliable estimates from existing sources of data.

The costs associated with a standard must also be reasonable in relation to the benefits provided. If contractors are required to use a liability basis that is inconsistent with other standards, there will be significant costs, monetary and otherwise, and most of these will be passed on to the government. For example, there will be additional expenses associated with a special valuation of pension liabilities. Moreover, forward pricing and budget projections will be more complex, and potentially less accurate, because contractors will need to forecast multiple sets of pension liabilities. Finally, disputes will be more likely, particularly with respect to the long-term investment return assumption. The compliance burden will be excessive, especially for smaller contractors.

These are material conflicts with the CASB objectives. We see no way to resolve the conflicts except to modify the CAS to require pension liabilities to be determined in a manner consistent with the measurements used for both ERISA and financial reporting. Specifically, the CAS should require the use of (i) the PUC cost method, and (ii) a discount rate that reflects the rates of return currently available on high-quality corporate bonds of appropriate duration. These changes would also improve consistency between contractors, a primary objective of the CAS.

The ANPRM notes that responses to the Staff Discussion Paper overwhelming support the adoption of a liability basis consistent with ERISA, as amended by the PPA. The Board narrowly interpreted the PPA liability as the amount computed for minimum funding purposes and rejected this approach because it does not represent the liability for an ongoing plan. We advocate the use of the PUC method, which is required for financial reporting and also for determining the PPA maximum tax deductible limit. The PUC approach reflects projected liabilities (including estimated future salary increases) and is appropriate for an ongoing plan.

The PUC cost method is acceptable under the current and proposed CAS and many contractors are already using this method. Therefore, the discount rate is the only material change required to eliminate the conflict and ensure consistency between the CAS and other pension standards. The CAS currently requires a discount rate based on the expected long-term rate of return on plan assets, whereas the rate used for other purposes is based on the current rate of return for high-quality corporate bonds. A discount rate based on high-quality bond rates is not inconsistent with an ongoing plan; it simply implies a reduced tolerance for risk. The requirement to use a rate based on current market rates instead of an assumed average long-term rate will increase cost volatility, but not excessively so. Historical data show that changes in high-quality bond rates typically occur slowly over time. Unless asset smoothing is applied, changes in liability will be partially offset by changes in the market value of fixed income securities held by the plan. In any event, the net change in unfunded liabilities resulting from fluctuations in bond rates will be amortized over a period of at least 10 years. While the added volatility is somewhat of a concern, we do not view it as a valid reason to reject this approach.

We concede that market-based bond rates may result in increased costs, but the increases may be less than expected. For plans that pay lump sums based on current bond rates in accordance with §417(e) of the Internal Revenue Code, the increased costs are probably already reflected to some degree. For plans that pay benefits not based on pay, and for many cash balance plans, costs will likely be determined under the minimum liability provisions of the proposed rule and will therefore reflect the lower interest rates even if the standard measurement basis is not changed. Finally, we expect that many contractors will move to lower their projected long-term rates of return and will cite the current economic situation as justification for the change. These cost increases will be amortized over as little as 10 years under the proposed rules but can be phased in more slowly under a transition rule if a change in the measurement basis is mandated.

We are sympathetic to the Board's desire to keep changes to a minimum and avoid a direct tie to ERISA that could have unintended consequences for contract cost accounting. Nevertheless, a CAS standard that requires employers to continue to use a cost measurement basis that is no longer utilized under other pension reporting standards is in conflict with the objectives of the CAS and contrary to the best interests of the government, contractors, and plan participants.

Changes in Current Bond Rates

If the measurement basis is modified to reflect current bond rates, we suggest that the rules provide that any change in liability attributable to interest rates will be treated as a gain or loss for cost purposes.

Prior to the PPA, it was standard practice to recalculate amortization payments if there was a change in the applicable interest rate. The PPA introduced a new methodology whereby the amortization amounts remain unchanged, and the difference in the present values is included in a new amortization base established as of the date of the change. For CAS purposes, this difference could be included in the gain and loss base. This method supports the objectives of the CASB because is easier to apply and reduces the volatility associated with interest rate changes. We therefore recommend that the CAS adopt this approach or allow it as an option without the need for advance approval.

Minimum Liability Provisions

While we support the recognition of a minimum liability for segment closing purposes, we believe that a requirement to adjust the actuarial accrued liability and normal cost used to compute the assignable pension cost adds a layer of unnecessary complexity and expense.

It is not the role of the CAS to ensure adequate funding of a plan's settlement liability. Nevertheless, contractors should be entitled to reimbursement for contributions required to meet the minimum funding standards under ERISA. In our opinion, the mandatory prepayment provisions (with minor changes to the proposed rules) will ensure that required contributions can be recovered within a reasonable period of time.

As written, the minimum liability adjustment to the assignable cost presents a number of technical concerns. It has limited value as a tool to ensure funding adequacy because it is compared to the actuarial asset value and not market value. Also, since the determination as to whether the minimum liability applies is done at the segment level, the costs for each segment may be inconsistent and the resulting cost for the total plan may be overstated. Finally, because the determination of whether the minimum liability applies is made without regard to the normal costs, the total cost for a period may be less if the minimum liability is required than it would be without the adjustment.

The minimum liability provisions will unfairly benefit only a select group of contractors, primarily those with non-pay-related and cash balance plans for which the accrued benefit liability is essentially the same as the projected benefit liability. For many others, the minimum liability provisions are unlikely to have any impact except upon segment closing. Consequently, consistency between contractors is a major issue.

It should be noted that the special minimum liability provisions will be unnecessary, for segment closing or cost purposes, if the Board adopts a measurement basis consist with the PPA and FAS, as previously recommended.

Interest Credited to Voluntary Prepayment Balances

Additional guidance is required for computing the actual rate of return to be applied to voluntary prepayment balances. The actual rate of return should not be the same as the net rate of return used to allocate investment income between segments because that rate is net of expenses; that is, voluntary prepayments should not share in plan administrative expenses that are not investment related. Since the effort and expense required to separately identify investment-related expenses for this purpose are not warranted, we recommend that the Board modify the definition of the actual rate of return to require that the rate be calculated without regard to expenses and in a manner otherwise consistent with the PPA.

The rationale for crediting an actual rate of return to prepayment balances is valid. However, if asset smoothing is used, prepayment balances must first be subtracted from plan assets in order to prevent unexpected results. The final standard should therefore specify that asset smoothing is to be applied to the assets after reduction for voluntary prepayment balances. This change in methodology should not require advance approval.

Mandatory Prepayments

Additional contributions made to avoid benefit limitations should be treated as a minimum required contribution for purposes of computing mandatory prepayment credits. These contributions are not added to the prefunding balance and may not be used to meet minimum funding requirements for the current year or for any future period. However, they will serve to reduce the minimum required contribution determined for future periods and the mandatory prepayment credits potentially available. Under the proposed standard, special contributions to avoid benefit limitations in excess of the assignable costs will be treated as voluntary prepayments and this may significantly delay reimbursement of those costs. This rule may therefore discourage or penalize contractors with severely underfunded plans from making additional contributions to avoid benefit restrictions.

We are also concerned about the requirement to treat carryover or prefunding (credit) balances as an offset to the minimum funding requirement for the current year. The proposed rule does not recognize that some employers will be prohibited from using credit balances to reduce current funding because of an inadequate funding level. Also, carryover balances, prefunding balances, and current period contributions are not interchangeable and there may be valid reasons for maintaining those balances. Finally, an employer who elects to retain a credit balance will have that balance counted against the funding requirement for mandatory prepayment purposes multiple times. As written, the proposed standard will penalize an employer for carrying or creating these balances and will therefore encourage lower levels of funding.

Finally, we question the reason for a one year lag between the period when mandatory prepayments are created and the period when they are first recognized for contract cost purposes.

Amortization Amounts

The proposed rule requires amortization payments to be based on the assumed long-term rate of return. If the liability measurement basis is changed to reflect current bond rates, the rules should clarify that amortization payments will be calculated based on the effective interest rate. Under ERISA/PPA, liabilities must be discounted using rates that vary by duration, but the plan actuary is required to determine and disclose the single effective interest rate that will produce an equivalent liability. This rate should be materially consistent with the single discount rate used for FAS purposes. The CAS rule does not need to tie directly to ERISA or FAS, but if the language is properly drafted, it will allow the liabilities and interest rate to be obtained directly from either an ERISA report or a FAS report. Such a rule will also avoid confusion with the PPA rules that require amortization payments to be discounted using the yield curve or segment interest rates.

The proposed rule requires mandatory prepayment charges to be recalculated if the balance is reduced by an amount in excess of the computed charge. We believe that this requirement is overly complex and prefer an approach that simply reduces the amortization period to reflect any excess payments. The PPA methodology for interest rate changes described in the preceding paragraph should also be permitted for amortization of mandatory prepayment balances. These changes will not only simplify the calculations but also improve the predictability of costs.

Transition Provisions

In general, we view the proposed transition provisions as inordinately complex, and the phase-in periods too long. In particular, we do not see a need to phase in the reduced amortization period for gains and losses. These costs (or credits) will not emerge until after the effective date of the revised standard. Unless the stock market recovers fairly quickly from its current lows, there may be significant market-related gains emerging during the transition period that could help to offset the increased costs anticipated under the revised rule. A phase in of the 10-year amortization period will diminish the impact of these potential gains.

Application of the Amended CAS Rules

The ANPRM states that the new rule will apply to the first cost-accounting period commencing after the later of (i) the date the final rule is published in the *Federal Register*, or (ii) the receipt of a contract or subcontract covered by the CAS. This rule may therefore have a delayed effective date for many CMS contractors who operate under 5-year contracts. Since the new rule is intended to resolve conflicts between the CAS and the PPA, we believe there should be a provision to allow a contractor to adopt early compliance, subject to the approval of the Contracting Officer.

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Thank you for this opportunity to comment on the proposed CAS Pension Harmonization rule. We would be pleased to answer any questions relating to our comments or recommendations.

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