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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 respectfully submit our response to the CAS pension harmonization Advance Notice of Proposed Rule Making (ANPRM) and appreciate the CAS Board's consideration of our comments.

Background

In order to better understand and appreciate the requirement for the CAS Board to harmonize CAS sections 412 and 413 with the funding provisions of the Pension Protection Act of 2006 (PPA) it would help to revisit some history. In the 1970's the CAS pension cost and the ERISA funding calculations were very much in synch with each other. This situation allowed government contractors that sponsored defined benefit pension plans to make contributions to those plans in an amount that was recoverable from the customer in the period in which the contribution was made. This is a fundamental concept that exudes very basic logic. CAS and ERISA, though separate standards, worked together to allow for systematic measurement, funding and recovery of pension cost. This accomplished two goals. First, from a perspective of equity, since pension cost is generally an allowable and acceptable cost for a government contractor, it provided an equitable way for the contractor to be reimbursed for this cost. Second, it allowed government contractors, at least from a pension cost perspective, to operate their businesses in an efficient manner and be positioned to better respond to the needs of their customers.

Then in 1987 some changes were made to ERISA that introduced some new concepts to the funding calculations. ERISA adopted the calculation of an accrued liability where the underlying interest assumption was based on bond yields. Other changes were also made to ERISA which included adjusting the time period for amortizing changes in the unfunded accrued liability. There were no corresponding or similar changes made to the CAS. We consequently entered a new era where there was often a clear divergence between the CAS assignable cost and the required

funding per ERISA. In some cases government contractors were forced to make cash contributions to pension trust funds with no ability to recover those amounts in the near

term. This penalty situation was an unintended consequence of the changing pension landscape.

The passage of the PPA eliminated the ERISA liability calculation that was based on the expected long-term rate of return on assets, so that it now solely relies on a liability that is based on bond yields. And under the new law, the bond yields are spot rates (or a 24-month average of spot rates) that will obviously fluctuate from year to year. These changes to the ERISA liability calculations, along with other changes imposed by the PPA such as the amortization periods for changes in the unfunded liability and changes in the ability to smooth valuation assets, will likely cause a significant variance between the cash funding requirements under ERISA and the assignable cost determined under CAS for a particular year. Absent any changes to the CAS, this will exacerbate the inequity in the recoverability of pension cost and will provide a challenge for many government contractors to operate at optimal efficiency when serving the needs of their customers.

The requirement for the CAS to harmonize with the PPA funding rules reflects the fact that Congress has recognized the need to restore equity to this situation. The legislators have acted to change the pension funding rules and have also mandated corresponding changes to the CAS that will allow the two sets of rules to co-exist in a cooperative manner. Pension cost is a necessary expense associated with business operation. The financial success of government contractors should be based on the success of the customer programs. Neither the contracting companies, nor the government, should be in a position to lose money, or make money, because of discrepancies in pension cost rules. The funding rules have been changed by the PPA. Now the CAS needs to change in a way that will attempt to minimize potential inequities for both the contractors and the government.

We appreciate the effort put forth by the CAS Board and Staff to study the issues and publish this ANPRM. The task of harmonization is challenging and technically complicated. The harmonization of CAS needs to respect the cash contribution requirements mandated by the PPA, but it should be done in a way that best allows both contractors and the government to budget for that cost and for the contractors to recover that cost. The ANPRM provides an excellent framework for developing revisions to the CAS in order to satisfy the requirements for harmonization with PPA. However, we believe that there are several areas where changes to the ANPRM would offer significant improvement toward meeting the objective of harmonization.

Measurement of Minimum Actuarial Liability

One item that we feel is very important pertains to the measurement of the "minimum actuarial liability" (MAL). The MAL that was introduced by the ANPRM corresponds to the PPA funding liability that is calculated using an interest rate based on bond yields. The PPA liability is based on spot bond rates (or a 24-month average of spot rates). Since those bond rates will fluctuate from year to year, and sometimes those fluctuations could potentially be very dramatic, the liability itself could fluctuate dramatically from year to year. According to the ANPRM the MAL is based on an interest rate assumption that "shall reflect the contractor's best estimate of rates at which the pension benefits could effectively be settled based on the rates of return on high-quality fixed-income investments of similar duration to the pension benefits." It is our understanding that the CAS Board intends this to mean that the MAL interest rate should reflect spot rates each year on high-quality bonds. Therefore, similar to the PPA

liability, the MAL under CAS should fluctuate from year to year as bond rates move upward or downward.

This result is not consistent with the fundamental desire to strive for predictability of cost in the government contracting arena. The impact that unforeseen changes in cost can have on fixed priced contracts is obvious, but even unexpected cost increases on flexibly priced business can place a strain on government budgets. It is important to try to mitigate the potential pitfalls that might create inequitable financial results for either the government or the contractors.

The ANPRM maintains the concept of the actuarial accrued liability (AAL) that is calculated using an interest rate that represents the average long-term expected return on the pension trust fund. This reflects the CAS Board's view of pension funding as a long-term proposition. The ANPRM states that CAS 412 and 413 are concerned with long-term pension funding and minimizing volatility to enhance predictability. Since the new MAL is based on spot bond rates it will experience more volatility from year to year than the AAL. We believe that the addition of the MAL to the CAS calculations is an important change that is very much needed. However instead of measuring the MAL using spot bond rates each year, we feel very strongly that it is important to allow contractors to have an option to calculate the MAL using an expected long-term average bond rate. This would allow contractors to use an interest assumption that would not need to be changed each year, and would very significantly reduce the volatility of the MAL and greatly improve predictability of the pension cost. The MAL interest assumption would only need to be changed if it was determined that average future bond yields over a long-term horizon were expected to be materially different from the current MAL assumption. For example, if long-term bond rates were expected to fluctuate between 5.5% and 6.5% in the future, then a valid assumption for the expected average future rate might be 6.0%. So this concept would hold some similarities to the interest rate used for calculating the AAL. The main difference is that the AAL interest rate represents the average expected long-term future return on the investment portfolio, whereas the MAL interest rate would represent the average expected future long-term yield on high-quality corporate bonds. There should obviously be some correlation between the MAL interest rate and the AAL interest rate, so the two different rates should be determined on a consistent basis.

As we mentioned above we believe that this change to the MAL interest rate would significantly reduce the volatility of the MAL and significantly improve predictability of the assignable pension cost each year. In addition, an average rate for the MAL should be acceptable for the preparation of the forward pricing calculations. If contractors had no other options but to use a spot rate for calculating the assignable cost then that would raise the obvious question regarding what assumption should be used for projecting the MAL for forward pricing. If at some point in time we believe that we are currently in a very high interest rate environment would the government readily allow contractors to use lower MAL interest rates for projecting costs in future years? The use of an average rate assumption would seem to be one way in which to solve that debate.

We believe that contractors should be able to use a spot interest rate for the calculation of the MAL if they feel that would provide a closer match to the cash contributions required by the PPA. A couple of examples of possible acceptable spot rates might be the same rate that is used for the liability calculation under the PPA or the discount rate that is used to calculate the PBO under FAS 87. But we also feel that it is important to allow for contractors to have the ability to use the alternative approach

of an expected average long-term interest rate for the MAL. The advantages to contract pricing of allowing this alternative approach are obvious. This would better allow ERISA and CAS to co-exist in an environment that reduces potential financial inequities between the government and contracting companies, which is one of the themes of harmonizing the CAS with the PPA. In order to achieve the harmonization objective mandated by the Congress we feel that this is an important item that demands the consideration of the CAS Board.

Application of Minimum Actuarial Liability

Another item that deserves some attention is the application of the MAL and its associated normal cost. The ANPRM includes a trigger that determines if the accrued liability will be equal to the AAL or equal to the MAL (and also if the normal cost will be equal to the AAL normal cost or the MAL normal cost). The mechanism for the trigger in the ANPRM is a straight comparison of the AAL and the MAL. We strongly believe that it would be more appropriate to have a trigger that is based on a cost comparison as opposed to a trigger that is based on a comparison of the liabilities. If the MAL and its respective normal cost would generate a higher cost than the AAL and its respective normal cost, then we should use the MAL and its normal cost to calculate the assignable cost for the year. If the opposite was true, then we should use the AAL and its normal cost to calculate the assignable cost for the year. So the mechanism for the trigger would be to calculate a) the annual amortization of the difference between the MAL minus AAL, and then add b) the difference between the MAL normal cost minus the AAL normal cost. Then if the sum of the two resulting amounts under (a) and (b) above added to a number that is greater than zero, then we would use the MAL and its normal cost to calculate the assignable cost for the year. If the sum of the two amounts under (a) and (b) above should be less than, or equal to, zero, then we would use the AAL and its normal cost to calculate the assignable cost for the year. This approach would really help to ameliorate potential volatility in the cost amounts from year to year by reducing the likelihood of changing back and forth between the AAL and the MAL and the respective normal cost amounts each year.

As we have already mentioned, the use of the MAL, if properly measured, would help to achieve the goal of harmonization with PPA. But proper application is also needed to better reflect the objective of achieving harmonization with the PPA. If this could be done in a way that reduces potential volatility in cost from year to year then this will obviously help to reduce potential financial inequities between the government and the contracting companies.

Prepayment Credits

We understand and appreciate the need to distinguish between mandatory prepayment credits and voluntary prepayment credits. It would not be fair to the government for a contractor to make a huge pension contribution that is well in excess of both the PPA required contribution and the CAS assignable cost, and then for the government to reimburse that contractor for that excessive contribution through a 5-year amortization. However, there a couple of issues with the application of prepayment credits under the ANPRM.

As currently drafted inequities would result between a contractor that contributes two years worth of cost in one year, and another contractor that contributes an amount in each year that is equal to the cost that applies to that year. For example, suppose the PPA required funding for Contractor A is $500 more than the CAS assignable cost

in each year, and the same fact also applies to Contractor B. Now suppose that in year 1 Contractor A contributes the PPA required funding for both year 1 and year 2. Then Contractor A would develop a prepayment credit in year 1 that is $1,000, and $500 of that amount would be classified as mandatory and $500 would be classified as voluntary. Ignoring interest, in years 2 through 6 Contractor A would increase the CAS recoverable cost by $100 each year to reflect the amortization of the mandatory prepayment credit.

Also assume that Contractor B contributes the amount of the PPA required funding in year 1, and contributes the amount of the PPA required funding in year 2. Then Contractor B would develop a prepayment credit of $500 in year 1 and another prepayment credit of $500 in year 2. Both of these prepayment credits would be classified as mandatory. Ignoring interest, in year 2 Contractor B would increase the CAS recoverable cost by $100, in years 3 through 6 the recoverable cost would increase by $200, and in year 7 the recoverable cost would increase by the final amortization payment of $100.

In this simple example we have two contractors with contribution amounts in excess of the CAS cost that are identical. But because of timing differences Contractor B would realize a higher recoverable cost in years 3 through 7. It would not be equitable to penalize Contractor A for preferring contributions in year 1. This situation could be corrected by allowing Contractor A to re-classify its $500 of voluntary prepayment credits in year 2 and consider them to switch to mandatory prepayment credits beginning in year 2. This would allow contractors that make contributions that are equal in amount to be treated the same, and it would not discourage contractors from making advanced contributions when circumstances would allow that to happen.

An associated issue relates to the determination of the amount of the prepayment credits. In our simple example, we have illustrated that the inequity outlined above could be corrected by allowing Contractor A to treat its voluntary prepayment credit as a re-classified mandatory prepayment credit in year 2. This would be supported by the fact that the PPA required funding is $500 more than the CAS assignable cost, so there should be a mandatory prepayment credit of $500 that applies to year 2 for Contractor A. However, that calculation is based on the assumption that the prepayment credit is equal to the excess of the PPA minimum required funding over the CAS assignable cost, where the PPA minimum required funding is not reduced by the ERISA credit balance.

Because of the extra contributions made by Contractor A in year 1, Contractor A would develop an ERISA credit balance that is equal to the PPA required contribution for year 2. Therefore, the mandatory prepayment credit that would apply to year 2 would be less than $500 for contractor A if we should follow the provisions of the ANPRM. This result would once again place Contractor A at a disadvantage when compared with Contractor B, but it could be corrected by clarifying that the mandatory prepayment credit is equal to the excess of the ERISA minimum required funding over the CAS assignable cost, where the ERISA minimum required funding is not reduced by the credit balance.

We believe that these changes would satisfy the objective of achieving equity and better align the CAS with the goals of harmonization.

Effective Date

We would urge the CAS Board to clarify that the effective date of any final rule will be delayed until pension plan years beginning on or after January 1, 2011. The

PPA requires the CAS Board to publish a final rule by January 1, 2010. The Board could fulfill its obligation by publishing a final rule within that timeframe, but have it become effective in 2011. This would allow contractors to have some time to recognize the impact in forward pricing. The contracting community has already received a directive from within the Department of Defense that prohibits any harmonization changes to be reflected in forward pricing until a final rule is published. To the extent that changes to the CAS could pro-actively be reflected in forward pricing it will ameliorate the need for equitable adjustments on contracts. It seems likely that a final rule probably won't be published until late in 2009. If the rule is then effective in 2010 there would not be any time for contractors to properly plan for, and to forward price, those changes. Having a delayed effective date would be a reasonable way of dealing with this problem. Another approach would be to allow contractors to currently update forward pricing even though the final changes to the CAS have not yet been determined. It is unlikely that the Department of Defense would support that approach. Therefore we feel that the CAS Board should clarify that the effective date would not be until 2011.

Other Provisions

We support the change from 15 years to 10 years in the amortization period for actuarial gains and losses. However, we do not agree with the 5-year transitional period that gradually reduces the amortization period. There is no advantage to the transitional period as it only adds unnecessary complexity. If the Board believes that the current 15-year period delays recognition too far beyond the emergence of the gain or loss, and that 10 years is more appropriate, then there should simply be a change made from 15 years to 10 years. We don't believe that the impact on the cost would be material enough to justify adding a transition period for this change.

We also do not believe that there should be a transitional provision for the amortization period that applies to mandatory prepayment credits. We don't understand the desire to establish a transitional period that roughly matches the typical contracting cycle. It would be more appropriate for the amortization period (as opposed to the transitional period) to roughly match the typical contracting cycle. This would more closely follow the themes of the FAR and CAS that prefer to match cost with the contracts under which that cost arose, and would also more closely follow the goal of harmonization with the PPA. So the amortization period for mandatory prepayment credits should simply be established at 5 years with no transition. If the government has a concern regarding the possible magnitude of legacy prepayment credits that have been created prior to the effective date of the harmonization rule then the government should try to collect some data regarding the amount of those legacy prepayment credits. If such data should demonstrate that the amortization amounts related to the legacy mandatory prepayment credits would impose a difficult financial burden on the government then perhaps a longer amortization period (longer than 5 years) should be established for the legacy mandatory prepayment credits.

The ANPRM implies that any change in actuarial asset method would be considered as a voluntary change in cost accounting practice, even if a contractor wanted to adopt the same actuarial asset value that is used for calculating ERISA costs under the provisions of the PPA. We feel that such a change should not be considered as a voluntary change in cost accounting practice. The introduction of the MAL will better align the CAS accrued liability with the ERISA liability. If a contractor determines that aligning the actuarial asset value with the ERISA asset value would enhance the

objective of achieving harmonization then that specific change should explicitly be allowed.

In a case where ERISA would require a cessation of benefit accruals for an “at risk” plan the ANPRM exempts that situation from the segment closing adjustment under CAS 413. We would suggest that CAS Board take this a step further and remove a curtailment of benefits as one of the triggers for a segment closing adjustment. This provision is unnecessary if the contractor is still conducting business with the government. The ongoing calculation of annual assignable cost could easily continue for a pension plan with frozen benefits. Implementing a segment closing adjustment would only provide incentive for the contractor to terminate the frozen plan and settle the pension obligations through annuity purchases and lump sum payments. That would only reduce the amount of any excess assets or increase the amount of any funding shortfall, which would then become an obligation of the government. It would seem to be advantageous to both the government and the contracting companies for the CAS Board to make this change.

We also support and have added our signature to a response to the ANPRM that was prepared jointly by the Aerospace Industries Association and the National Defense Industrial Association. We request the CAS Board to also give careful consideration to the comments prepared by the AIA and NDIA.

Closing

We would like to reiterate that the law requires the CAS to harmonize with the PPA. The law does not explicitly state that the CAS assignable cost needs to be equal to the required contributions under PPA. The reason for that is that government contracting has idiosyncrasies that require special attention. Pension contributions required by the PPA are allowable cost for which contractors should be reimbursed within a reasonable amount of time. Harmonization calls for the CAS to embrace the cost concepts contained in PPA, but to be applied in a way that best allows contractors to budget and recover the pension cost and for the government to budget the cost. To achieve harmonization the two sets of rules need to respect each other and to co-exist in a mutually friendly environment.

If you should have any questions or require any additional information please contact:

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Sincerely,

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