## OFFICE OF MANAGEMENT AND BUDGET

### Office of Federal Procurement Policy

### Cost Accounting Standards: Staff Discussion Paper—Harmonization of Cost Accounting Standards 412 and 413 with the Pension Protection Act of 2006

**AGENCY:** Cost Accounting Standards Board, Office of Federal Procurement Policy, OMB.

**ACTION:** Notice.

**SUMMARY:** The Office of Federal Procurement Policy, Cost Accounting Standards Board, invites public comments concerning a Staff Discussion Paper on the harmonization of Cost Accounting Standards 412 and 413 with the Pension Protection Act of 2006.

**DATES:** Comments must be in writing and must be received by September 4, 2007.

**ADDRESSES:** Due to delays in OMB's receipt and processing of mail, respondents are strongly encouraged to submit comments electronically to ensure timely receipt. Electronic comments may be submitted to *casb2@omb.eop.gov.* Be sure to include your name, title, organization, and reference case ''CAS–2007–02S.'' Comments may also be submitted via facsimile to (202) 395–5105. If you must submit via regular mail, please do so at Office of Federal Procurement Policy, 725 17th Street, NW., Room 9013, Washington, DC 20503, ATTN: Laura Auletta. Please note that all public comments received will be posted in their entirety, including any personal and/or business confidential information provided, at *http://www.whitehouse.gov/omb/procurement/casb.html* after the close of the comment period.

**FOR FURTHER INFORMATION CONTACT:** Eric Shipley, Project Director, Cost Accounting Standards Board (telephone: 410–786–6381).

**SUPPLEMENTARY INFORMATION**

### A. Regulatory Process

Rules, Regulations and Standards issued by the Cost Accounting Standards Board (Board) are codified at 48 CFR Chapter 99. The Office of Federal Procurement Policy Act, 41 U.S.C. 422(g), requires that the Board, prior to the establishment of any new or revised Cost Accounting Standard (CAS or Standard), complete a prescribed rulemaking process. The process generally consists of the following four steps:

1. Consult with interested persons concerning the advantages, disadvantages and improvements anticipated in the pricing and administration of Government contracts as a result of the adoption of a proposed Standard.
2. Promulgate an Advance Notice of Proposed Rulemaking.
3. Promulgate a Notice of Proposed Rulemaking.
4. Promulgate a Final Rule.

This proposal is step one of the four-step process.

### B. Background and Summary

The Office of Federal Procurement Policy (OFPP), Cost Accounting Standards Board, is today releasing a Staff Discussion Paper (SDP) on the harmonization of Cost Accounting Standards (CAS) 412 and 413 with the Pension Protection Act (PPA) of 2006 (Pub. L. 109–280, 120 Stat. 780). The Office of Procurement Policy Act, 41 U.S.C. 422(g)(1), requires the Board to consult with interested persons concerning the advantages, disadvantages, and improvements anticipated in the pricing and administration of Government contracts as a result of the adoption of a proposed Standard prior to the promulgation of any new or revised CAS.

The PPA amended the minimum funding requirements and tax-deductibility of pension plans under the Employee Retirement Income Security Act of 1974 (ERISA). The PPA requires the Board to revise Standards 412 and 413 of the CAS to harmonize with the amended ERISA minimum required contribution not later than January 1, 2010.

This SDP solicits public views with respect to the Board's statutory requirement to ''harmonize'' CAS 412 and 413 with the PPA. Differences between CAS 412 and 413 and the PPA, and issues associated with pension harmonization have been identified by the staff. Respondents are welcome to identify and comment on any issues related to pension harmonization that they feel are important. This SDP reflects research accomplished to date by the staff of the Board in the respective subject area, and is issued by the Board in accordance with the requirements of 41 U.S.C. 422(g). Accordingly, this SDP does not necessarily represent the position of the Board.

Basic conceptual differences exist between the CAS and the PPA that affect all contracts and awards subject to CAS 412 and 413. The PPA utilizes a settlement or liquidation approach to value pension plan assets and liabilities, including the use of accrued benefit obligations and interest rates based on current corporate bond rates. On the other hand, CAS utilizes the going concern approach to plan asset and liability valuation, *i.e.*, assumes the company (or in this case the pension plan) will continue in business, and follows accrual accounting principles that incorporate assumptions about future years of employees' service and salary increases that are absent from the settlement approach.

To comply with the Congressional mandate in Section 106 of the PPA (Section 106), the Board must complete its statutorily required 4-step promulgation process no later than January 1, 2010. Therefore, the Board has determined that this case must be limited to pension harmonization issues. As always, the public is invited to submit comments on other issues regarding contract cost accounting for pension cost that respondents believe the Board should consider. However, comments unrelated to pension harmonization will be separately considered by the Board in determining whether to open a separate case on pension costs in the future. The staff continues to be especially appreciative of comments and suggestions that attempt to consider the concerns of all parties to the contracting process.

### C. Public Comments

Interested persons are invited to participate by providing input with respect to harmonization of CAS 412 and 413 with the PPA. All comments must be in writing, and submitted as instructed in the **ADDRESSES** section.

### D. Staff Discussion Paper—Harmonization of Cost Accounting Standards 412 and 413 with the Pension Protection Act of 2006

*I. Introduction*

The PPA made substantial amendments to ERISA. In particular, the PPA's minimum required contribution provisions, which apply to single employer qualified defined-benefit plans, are very different from the basic minimum funding requirements of ERISA that have existed since 1974. The PPA minimum required contribution computation also differs from the measurement and assignment provisions of CAS 412 and 413.

The PPA is generally effective as of January 1, 2008. In Section 106, Congress instructs the Board to:

''* * * review and revise sections 412 and 413 of the Cost Accounting Standards * * * to harmonize the minimum required contribution * * * of eligible government contractor plans and government reimbursable pension plan costs not later than January 1, 2010.''

The PPA requires that any revisions to the CAS be called the CAS ''Pension Harmonization Rule.'' Section 106 defines ''eligible government contractors'' as entities whose primary business is performing work under contracts subject to the Federal Acquisition Regulation and the Defense Federal Acquisition Regulation Supplement (DFARS) with such revenues exceeding $5 billion annually. While the Board is considering what action, if any, is needed to harmonize the CAS with the PPA, these ''eligible government contractors'' have been granted relief from the minimum required contribution and ''at risk'' provisions of Title I of the PPA.

*II. Scope of the SDP*

The PPA addresses many aspects of the treatment of pension plans under ERISA. As part of Title I of the PPA, Section 106 applies to single employer defined benefit plans only. Therefore, this SDP requests public comment on what revisions to the provisions of CAS 412 and 413 regarding single employer defined benefit pension plans, if any, are required to ensure pension harmonization.

Section 106 instructs the Board to harmonize the CAS with the minimum required contribution for ''eligible government contractors.'' The Board has determined that the scope of this SDP will (1) Include discussions regarding all contractors with contracts, grants or awards subject to these Standards and (2) consider if and/or how the CAS should be revised to address both the PPA minimum required contribution and maximum tax-deductible amounts to achieve harmonization.

*III. Background*

The rules governing defined-benefit pension costs for financial accounting, ERISA and CAS were developed for different purposes. The purpose of financial accounting is to report the annual pension expense and pension liability for use by shareholders, lenders, and other users of the entity's financial reports. Financial accounting recognizes the benefit liability presuming the pension plan will be ongoing unless there is evidence to the contrary.

ERISA was passed in 1974 in response to widespread abusive practices that prevented retirees from receiving promised pension benefits. ERISA established a minimum funding requirement for benefit security purposes and imposed a funding limit for tax policy purposes, but did not establish accounting practices for pension costs. The minimum contribution requirement and the maximum tax-deductible limitation were measured on a projected benefit (going concern) basis. ERISA has been amended several times to implement tax policy and protect the benefits of plan participants.

In its 1992 Statement of Objectives, Policies, and Concepts (57 FR 31036, July 13, 1992), the Board stated that the primary purpose of the CAS is to ''achieve (1) An increased degree of uniformity in cost accounting practices among Government contractors in like circumstances, and (2) consistency in cost accounting practices in like circumstances by individual Government contractors over periods of time.'' The Board addresses the recognition of pension costs in CAS 412 and 413. CAS 412 provides ''guidance for determining and measuring the components of pension cost'' and ''the basis on which pension costs shall be assigned to cost accounting periods.'' CAS 413 provides ''guidance for adjusting pension cost by measuring actuarial gains and losses and assigning such gains and losses to cost accounting periods.'' CAS 413 also provides ''the bases on which pension cost shall be allocated to segments of an organization.''

The original CAS 412 and 413 were revised in 1995 in part to address a conflict introduced by the Tax Reform Act of 1986 (TRA 86) and the Omnibus Budget Reconciliation Act of 1987 (OBRA 87). TRA 86 imposed an excise tax on contributions that exceeded the tax-deductible limit. OBRA 87 lowered the ERISA funding limitations which put contractors in a ''catch-22'' situation. Contractors were faced with the dilemma of either funding the full pension cost determined under CAS while incurring a substantial excise tax which was not an allowable cost for Government contracting purposes, or limiting the pension contribution and losing current and future recognition of the costs which would have otherwise been measured and assigned as pension costs on Government contracts. On March 30, 1995, CAS 412 and 413 were amended and removed the conflict by limiting the assignable pension costs to a corridor measured by a zero dollar floor and ERISA's maximum contribution amounts. The measurement and assignment of pension cost under CAS 412 and 413 continued to be based on traditional accrual accounting and long-term assumptions, which matches activities to the cost of the long-term liability for pensions, and required funding to substantiate the compellable amount. The preamble to the 1995 amendments to CAS 412 and 413 (60 FR 16534, March 30, 1995) reiterated the relationship between the Standards and ERISA:

This final rule has not adopted ERISA as an accounting method, but has modified accrual accounting to fit within the confines of practicable funding.

*IV. ERISA Contributions vs. CAS Cost*

ERISA, as amended by OBRA 87, obligates plan sponsors, including Government contractors, to make minimum pension contributions towards their unfunded accrued benefit liabilities, which are measured on a settlement basis. However, in some cases Government contractors are not reimbursed immediately for the higher cash outlays in their government contract costs and prices. Instead, the extra contribution is accounted for as a prepayment credit which is deferred and reimbursed in later years. As a result, many contractors have expressed serious concerns about the detrimental impact on their current cash flow. The PPA may further exacerbate this cash flow issue by increasing the differences between required ERISA funding and the measurable and assignable cost under CAS.

*V. Relationship of CAS 412 and 413 to ERISA and ''Harmonization''*

Congress instructed the Board to ''harmonize'' the CAS with the minimum required contribution. However, neither the Act nor the Joint Committee on Taxation report on the PPA (Technical Explanation of H.R. 4, the ''Pension Protection Act of 2006,'' as passed by the House on July 28, 2006, and as considered by the Senate on August 3, 2006, JCX–38–06, August 3, 2006) give any guidance or insight as to Congress' meaning of the word ''harmonize.'' Thus, the Board has the responsibility of interpreting the term ''harmonization,'' and in fact, under the OFPP Act, the Board has the exclusive authority to promulgate, amend, and interpret the Cost Accounting Standards.

This leads to the question of what it means to harmonize the two sets of rules.

*VI. Questions*

This SDP seeks public input on possible revisions to CAS 412 and/or 413 to ''harmonize'' the CAS and the PPA. Therefore, the Board requests input from interested parties on the following areas of concern. The Board welcomes comments on any other concerns, issues or input related to harmonization of the CAS with the PPA.

1. *Scope.* Section 106 of the PPA instructs the Board to harmonize the CAS with the minimum required contribution for ''eligible government contractors.'' Contracts of ''eligible government contractors'' are a small subset of contracts subject to CAS 412 and 413, which include all cost-based contracts subject to full CAS–Coverage, contracts subject to Paragraph 31.205–6(j) of the Federal Acquisition Regulation, and recipients of financial assistance who have elected to use CAS 412 and 413 under OMB Circular A–87.

*Question 1.* Should the Board apply any revisions to all cost-based contracts and other Federal awards that are subject to full CAS coverage, or only to ''eligible government contractors'' as defined in Section 106?

2. *General Purpose.* CAS 413.50(c)(12) currently provides for an adjustment of previously determined pension cost in the event of a segment closing, a plan termination, or a curtailment of benefits. The adjustment is computed as the difference between the market value of the assets and the actuarial accrued liability for the segment. If there is a pension plan termination, the actuarial accrued benefit is measured as the amount paid to irrevocably settle all benefit obligations or paid to the PBGC. In this way, it could be argued that CAS 413–50(c)(12) already satisfies the purpose of the PPA to protect employee retirement security or to ensure the PBGC solvency, at least for the contractor's segments that perform Government contracts. This leads to the following question:

*Question 2.* Does the current CAS 412 and 413 substantially meet the Congressional intent of the PPA to protect retirement security, to strengthen funding and ensure PBGC solvency?

3. *Harmonization.* The PPA requires that the Board review and revise CAS 412 and 413 to harmonize with the minimum required contribution, but recognizing that the Board has exclusive authority concerning contract cost accounting, leaves the determination of what constitutes ''harmonization'' to the Board's deliberation and conclusion. The CAS pension harmonization rule could fall anywhere within the continuum from avoidance of conflict with ERISA to full adoption of the measurement and assignment concepts of the minimum required contribution. The rule might be accomplished by changing the current provisions of CAS 412 and 413, or possibly adding an adjustment mechanism to ensure differences between the minimum required contribution and the contract cost are reconciled within a reasonable period of time. There might be other means by which harmonization could be achieved.

Another issue is whether harmonization should examine the minimum required contribution with or without application of the plan's credit (carryover and prefunding) balances. The existence and application of credit balances are treated differently for eight separate PPA funding tests, such as ''at-risk'' status, benefit restrictions, and the variable PBGC premium. Separate from their concerns with contract costing, contractors will have to make complex decisions about whether to retain or waive (permanently forego) credit balances. If all or some of the credit balance is retained, the contractor must make decisions as to the amount of the credit balance to apply to reduce the minimum funding requirement and in which accounting period to apply the reduction.

*Question 3.* Should CAS harmonization be focused only on the relationship of the PPA minimum required contribution and the contract cost determined in accordance with CAS 412 and 413?

(a) Do the measurement and assignment provisions of the current CAS 412 and 413 result in a contractor incurring a penalty under ERISA in order to receive full reimbursement of CAS computed pension costs under Government contracts?

(b) To what extent, if any, should the Board revise CAS 412 and 413 to harmonize with the contribution range defined by the minimum required contribution and the tax-deductible maximum contribution?

(c) To what extent, if any, should ERISA credit balances (carryover and prefunding balances) be considered in revising CAS 412 and 413?

(d) To what extent, if any, should revisions to CAS be based on the measurement and assignment methods of the PPA?

(i) To what extent, if any, should the Board revise the CAS based on rules established to implement tax policy?

(ii) To what extent, if any, should the Board consider concerns with the solvency of either the pension plan, or the PBGC?

4. *Cost Measurement.* CAS measures the accrued pension liability and pension cost on the ''going concern'' basis of accounting that assumes the contractor and pension plan will continue lacking evidence to the contrary. Conversely, PPA measurements are made on liquidation or settlement cost basis.

*Question 4.* (a) Accounting Basis. For Government contract costing purposes, should the Board (i) Retain the current ''going concern'' basis for the measurement and assignment of the contract cost for the period, or (ii) revise CAS 412 and 413 to measure and assign the period cost on the liquidation or settlement cost basis of accounting?

(b) Actuarial Assumptions. For contract cost measurement, should the Board (i) Continue to utilize the current CAS requirements which incorporate the contractor's long-term best estimates of anticipated experience under the plan, or (ii) revise the CAS to include the PPA minimum required contribution criteria, which include interest rates based on current corporate bond yields, no recognition of future period salary growth, and use of a mortality table determined by the Secretary of the Treasury?

(c) Specific Assumptions. Please comment on the following specific assumptions:

(i) Interest Rate: (1) For measuring the pension obligation, what basis for setting interest rate assumptions would best achieve uniformity and/or the matching of costs to benefits earned over the working career of plan participants? (2) To what extent, if any, should the interest rate assumption reflect the contractor's investment policy and the investment mix of the pension fund?

(ii) Salary Increases: For measuring the pension obligation, should the CAS exclude, permit or require recognition of future period salary increases?

(iii) Mortality: For measuring the pension obligation, should the CAS exclude, permit, or require use of a (1) Standardized mortality table, (2) company-specific mortality table, or (3) mortality table that reflects plan-specific or segment-specific experience?

(d) Period Assignment (Amortization). For contract cost measurement, should the Board (i) Retain the current amortization provisions allowing amortization over 10 to 30 years (15 years for experience gains and losses), (ii) expand the range to 7 to 30 years for all sources including experience gains and losses, (iii) adopt a fixed 7 year period consistent with the PPA minimum required contribution computation, or (iv) adopt some other amortization provision?

(e) Asset Valuation. (i) For contract cost measurement, should the Board restrict the corridor of acceptable actuarial asset values to the range specified in the PPA (90% to 110% of the market value)?

(ii) For contract cost measurement, should the Board adopt the PPA's two year averaging period for asset smoothing?

5. *At Risk Plans.* For plans with a low level of funding, the PPA imposes certain provisions that may require higher ''at risk'' minimum required contributions than is required for plans that do not have this low level of funding. The ''at-risk'' provisions are intended to more rapidly fund plans that are likely to fail due to underfunding and be taken over by the PBGC.

*Question 5.* To what extent, if any, should the Board revise the CAS to include special funding rules for ''at risk'' plans?

*6. Cash Flow Considerations.* The PPA may create a disincentive for government contractors to continue their defined benefit plans if the pattern of cash outlays for pension contributions are not matched by the reimbursements for pension costs under Government contracts. The mismatching of cash flows might occur for two distinct reasons: (i) The pension costs assigned to a particular cost accounting period in accordance with CAS may be substantially less than the minimum contributions required by ERISA, or (ii) incurred pension costs may dramatically exceed previously forecast costs due to plans emerging from full funding and/or experiencing unexpected adverse asset or demographic results.

*Question 6.* (a) To what extent, if any, should the measurement and assignment provisions of CAS 412 and 413 be revised to address contractor cash flow issues?

(b) To what extent, if any, do the current prepayment provisions mitigate contractor cash flow concerns?

(c) To what extent, if any, should the prepayment credit provision be revised to address the issue of potential negative cash flow?

7. *Volatility in Contract Cost Projections.* The second potential source of cash flow mismatch is attributable not to the basic measurement and assignment provisions of the Standards, but to the volatility of contract costs for pensions and contribution requirements (see Question 5 above). The ''all or nothing'' effects of the CAS 412 assignable cost limitation and the ceiling on assigned cost for income tax purposes could significantly impact the volatility of contract cost forecasts.

*Question 7.* (a)(i) To what extent, if any, would adoption of some or all of the PPA provisions impact the volatility of cost projections? (ii) Are there ways to mitigate this impact? Please explain.

(b) To what extent, if any, should the CAS assignable cost limitation be revised as part of the efforts to harmonize the CAS with the PPA?

(c) To what extent, if any, should the CAS be revised to address negative pension costs in the context of cost volatility?

8. *Segment Closings, Plan Terminations, and Benefit Curtailments.* Under the PPA, if a plan is determined to be severely ''at-risk,'' the further accrual of benefits is prohibited. Under CAS 413, such a cessation of accrual would be a curtailment of benefits. Currently, if the contractor retains pension assets and liabilities subsequent to the curtailment of benefits, CAS 413–50(c)(12) requires that the actuarial liability be measured using the assumptions that have historically been used to fund the plan. If the liability is transferred to an insurance company or the PBGC, the insurance premium or PBGC valuation of the liability determines the segment closing liability. The cost of the insurance premium and the liability assumed by the PBGC may exceed the PPA target liability and the actuarial liability measured by CAS 413–50(c)(12) because of the addition of the ''risk premium'' against adverse experience assessed by insurers.

*Question 8.* (a) To what extent, if any, would adoption of some or all of the PPA provisions affect the measurement of a segment closing adjustment in accordance with CAS 413.50(c)(12)?

(b) To what extent, if any, should the CAS 413 criteria for a curtailment of benefits be modified to address the PPA mandatory cessation of benefit accruals for an ''at risk'' plan?

9. *Technical Issues.* The PPA changes the ERISA provisions for (a) Treatment of credit (carryover and prefunding) balances (analogous to ''prepayment credits'' under the CAS), (b) treatment of contributions made after the end of the plan year, and (c) recognition of collectively bargained benefits. CAS 412 requires prepayment credits to be adjusted at the valuation rate of interest (the CAS valuation rate) while the PPA requires credit balances to be adjusted based on the pension fund's actual rate of ''return on plan assets.'' CAS 412 and 413 do not contain specific language on the treatment of contributions made after the end of the plan year, while the PPA requires that such contributions to be discounted at the PPA ''effective interest rate.'' CAS 412 recognizes only the benefits specified in existing collective bargaining agreements, while the PPA recognizes anticipated changes in benefits based on established patterns.

*Question 9.* (a) Prepayment Credits. Should prepayment credits be adjusted based on the CAS valuation rate or the PPA requirement to use the pension fund's actual ''return on plan assets'' for the period?

(b) Contributions Made After End of Plan Year. Should the interest adjustment for contributions made after the end of the plan year be computed as if the deposit was made on the last day of the plan year or on the actual deposit as now required by the PPA?

(c) Collectively Bargained Benefits. (i) To what extent, if any, should the CAS be revised to address the PPA provision that allows the recognition of established patterns of collectively bargained benefits?

(ii) Are there criteria that should be considered in determining what constitutes an established pattern of such changes?

10. *Available Data on Costs under CAS vs. PPA.* To fully examine the relationship of the measurement and assignment of contract costs for pensions, the minimum required contribution, and the maximum tax-deductible contribution, the Board believes that data considering many different scenarios would be very informative and enhance its deliberations.

*Question 10.* The Board would be very interested in obtaining the results of any studies or surveys that examine the pension cost determined in accordance with the CAS and the PPA minimum required contributions and maximum tax-deductible contribution.

11. *Records and Visibility.* Beginning in 2008, actuarial valuation reports prepared for ERISA and financial accounting purposes will no longer be required to include the accrued actuarial liability and normal cost measured under cost methods and assumptions that comply with the provisions of CAS 412 and 413. Actuaries and valuation software could still produce such values, and such valuation results would still be subject to the Actuarial Standards of Practice.

*Question 11.* In light of the changes to the PPA, should the Board consider including specific requirements in CAS 412 and 413 regarding the records required to support the contractor's proposed and/or claimed pension cost?

**Paul A. Denett,**

*Administrator, Office of Federal Procurement Policy.*

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