

THE GOVERNMENT CONTRACTOR®



Information and Analysis on Legal Aspects of Procurement

Vol. 42, No. 40

October 25, 2000

Focus

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FEATURE COMMENT • *Heads We Win, Tails You Lose: The CAS Board's Remarkable New Proposal On Accounting For The Costs Of PRB Plans*

Those who were dismayed by the biased nature of the Cost Accounting Standards Board's 1995 promulgation of amendments to CAS 412, "Composition and measurement of pension cost," and CAS 413, "Adjustment and allocation of pension cost," will be equally disappointed by the Board's October 5, 2000 Advance Notice of Proposed Rulemaking on Accounting for the Costs of Post-Retirement Benefit Plans Sponsored by Government Contractors. See 65 Fed. Reg. 59504 (Oct. 5, 2000), 42 GC ¶ 398. In amending CAS 413, the Board was anxious to enable the Government to recover its "share" of contractors' surplus pension funds. See CAS 9904.413-50(c)(12). At the same time, however, the amended CAS 413 recognized the Government's obligation to "share" in pension *underfunding* when, for example, a contractor closes one of its business segments. *Id.* Proposed CAS 419 on post-retirement benefit (PRB) plans other than pensions does not evidence a similar willingness to ensure that the Government pays its "share" of contractors' underfunded PRB liabilities. To the contrary, the drafters' principal objectives appear to have been to avoid, decrease, or delay indefinitely the Government's obligation to pay its share of contractors' PRB costs, which, like other forms of employee compensation, are a legitimate element of the full cost of the goods and services the Government buys.

Background—PRBs include all forms of benefits, other than retirement income, that an employer promises to provide to its employees after retirement in exchange for their current

services. The most common forms of PRBs are health care, which accounts for approximately 80% of PRB liabilities, and retiree life insurance, which accounts for approximately 19% of the liabilities. See 61 Fed. Reg. 49534 (Sept. 20, 1996), 38 GC ¶ 456. Although PRBs frequently are offered as part of the same retirement package as pension benefits, there are a number of significant differences between pensions and PRBs. First, PRBs frequently provide entitlement to or reimbursement for a service, such as health care, and the actual amount of benefits paid will depend on the individual retiree's or beneficiary's health and longevity. Second, an employee's entitlement to PRBs often vests all at once upon retirement or upon meeting the employer's age and service requirements. Third, in stark contrast to the Employee Retirement Income Security Act treatment of pension benefits, the Internal Revenue Code discourages the pre-funding of post-retirement medical benefits. In fact, there are only two tax-advantaged means of funding PRBs: (1) through an IRC § 401(h) account, which permits the limited use of surplus pension assets to pay for current retiree health care benefits that are ancillary to the basic retirement benefit, and (2) through use of a Voluntary Employees' Beneficiary Association (VEBA) trust. See 26 USC § 501(c)(9). Although the earnings of union VEBAs are tax-exempt, the earnings of non-union VEBAs are subject to the Unrelated Business Income Tax, thus rendering VEBAs impracticable for many non-union contractors. Not surprisingly, therefore, most PRB plans are either underfunded or not funded.

Nevertheless, as the Financial Accounting Standards Board recognized in issuing Statement of Financial Accounting (SFAS) 106 in December 1990, PRBs are as much a cost of providing goods

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and services as any other cost of employee compensation, and sound accounting requires that the costs be recognized over the working lives of the employees earning the benefits. Accordingly, SFAS 106 requires that companies recognize and accrue net periodic PRB costs over the working lives of the employees earning the benefits, so that the employer's obligation for each employee's PRBs will be fully accrued for financial reporting purposes by the time the employee attains full eligibility for benefits. For most companies, SFAS 106 became effective in the first fiscal year after December 15, 1992. It permitted employers to choose one of two methods for recognizing the "transition obligation" (i.e., the accumulated PRB obligation for retirees and for active employees, during the period before implementation of SFAS 106). Employers could either immediately recognize the transition obligation or recognize it on a delayed basis over the plan participants' future service period. SFAS 106 ¶¶ 112, 113.

For Government contract accounting purposes, the Federal Acquisition Regulation limits recognition of PRB past services costs to those computed under the SFAS 106 "delayed recognition" methodology. FAR 31.205-6(o). Additionally, the FAR requires that PRB costs be funded to be allowable, which, because of the adverse tax consequences discussed above, effectively precludes many contractors from accruing PRB costs for Government contract purposes.

Tellingly, the prefatory comments accompanying the CAS Board's October 5 proposed PRB rule note that the development of the proposal was influenced by three major observations:

(1) While pension plans are generally fully-funded or over-funded, only about half of the PRB plans surveyed had any assets, and for those that did, the assets typically covered only one-third of the PRB obligation.

(2) While companies' reported PRB obligations are, on average, less than one-third of their reported pension obligations, the average PRB obligation is "still quite large."

(3) The average net periodic cost of PRBs is higher than the average net periodic cost of pensions.

Interestingly, the proposal also notes that "[m]ost respondents did not favor the promulgation of a new Standard and believed that the Board

could adequately address post-retirement benefit costs through amendments to CAS 9904.412 and 9904.413." 65 Fed. Reg. at 59505. In addition, "respondents almost universally agreed that accrual accounting following the provisions of SFAS 106 was the most appropriate basis for measuring and assigning the costs of a post-retirement benefit plan that created a firm liability." *Id.* Notwithstanding this consensus in the public comments, the CAS Board's PRB proposal is neither consistent with CAS 412 and 413 nor with SFAS 106.

Proposed Criteria Would Make It Virtually Impossible to Accrue PRB Costs—In its 1992 Statement of Objectives, Policies and Concepts, the CAS Board correctly observed that "[t]he basic premise of good cost accounting is that the measurement, assignment, and allocation of costs be based on the beneficial or causal relationship between those costs and cost objectives." 57 Fed. Reg. 31036 (July 13, 1992). Throughout the PRB rulemaking process, the Board repeatedly has acknowledged that accrual, and not cash, accounting affords the best matching of PRB costs to the benefiting contract activities. See, e.g., 61 Fed. Reg. at 49539; 65 Fed. Reg. at 59519. The Board also has acknowledged that accrual accounting enhances predictability, consistency, and uniformity. 61 Fed. Reg. at 49538–39. Inexplicably, however, the October 5 ANPRM establishes accounting criteria that would make it virtually impossible to accrue PRB costs over the working lives of the employees earning the benefits.

Under proposed CAS 9904.419-40(a), costs of PRB plans would be accounted for on an accrual basis only if (a) the promise of future benefits is communicated in writing to employees, including notice of the right to legally enforce payment, (b) participants have an irrevocable right to any portion of a benefit for which they have become eligible, (c) the contractor has not reserved the right to terminate, cancel, eliminate, or reduce a participant's right to any portion of the benefits for which the participant has become eligible, (d) the annual cost for a *defined-contribution* PRB

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plan is the contribution required by the written provisions of the PRB plan, and (e) the annual cost of a *defined-benefit* PRB plan is actuarially determined based on the written provisions of the PRB plan. 65 Fed. Reg. at 59528. Even if a defined-benefit plan meets these criteria, however, the proposal would still limit PRB costs assigned to a cost accounting period to the sum of the post-retirement benefits paid for the period (i.e., the pay-as-you-go or PAYG amount) and the unfunded nonforfeitable PRB obligation. 65 Fed. Reg. at 59529 (proposed CAS 9904.419-40(b)(5)). Proposed CAS 9904.419-30(a)(7) defines the “nonforfeitable [PRB] obligation” to mean “the accumulated post-retirement benefit obligation for benefits, or that portion of benefits, for which the participant’s eligibility to receive a present or future post-retirement benefit is no longer contingent on remaining in the service of the employer or attaining a specified age.” 65 Fed. Reg. at 59527. The “*unfunded* nonforfeitable [PRB] obligation” is the “excess, if any, of the nonforfeitable [PRB] obligation, including benefit eligibility as of the last day of the plan year, over the valuation assets.” *Id.* Because PRB costs generally vest at retirement or upon attaining the specified age and service levels necessary for retirement, the practical effect is that the proposal would delay the assignment of any accrued costs until the employee is eligible to retire.

The proposed measurement criteria and assignment limitation go well beyond what is reasonably necessary to ensure the existence of a “firm liability.” For purposes of determining allowability, for example, FAR 31.205-6(a)(3) requires only that compensation “be based upon and conform to the terms and conditions of the contractor’s established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.” The measurement criteria and assignment limitation in proposed CAS 419 also are at odds with the other compensation Standards—i.e., CAS 412 and 413, as well as CAS 408, “Accounting for costs of compensated personal absence,” and CAS 415, “Accounting for the cost of deferred compensation”—none of which requires that benefits be fully vested before the associated costs are recognized for Government contract cost accounting purposes.

Moreover, contrary to the statement in the Board’s prefatory comments, there was *not* a “general consensus” among the commenters “that in order for a post-retirement benefit to be recognizable, criteria similar to that found in CAS 412 requiring that the plan be in writing and communicated to the employees, *and that the benefits be materially nonforfeitable* should be applied. 65 Fed. Reg. at 59516 (emphasis added). For example, The Boeing Co. and the General Electric Co. commented that an enforceable obligation to pay PRBs can result from (1) a collective bargaining agreement, (2) a contractor’s established pattern and practice of making the payments, (3) a contractual agreement with the Government, or (4) the threat of a civil action if the benefit is not paid. The Aerospace Industries Association and the National Defense Industrial Association commented that the “Government’s concern for protecting its interest should a PRB plan be curtailed or terminated” is adequately “addressed through the incorporation of a contract clause [such as FAR 52.215-18, “Reversion or Adjustment of Plans for Postretirement Benefits (PRB) Other than Pensions”] that requires a contractor to reimburse the Government for its share of any over-accrued PRB costs resulting from a plan curtailment or termination.” Fidelity Investments observed that the FASB has already addressed the issue of whether PRB obligations represent “valid liabilities,” and commented that “it would make no sense for the CAS Board, with far fewer resources, to revisit this complicated question.” Cordant Technologies similarly commented that “the existence of a ‘substantive plan’ establishes PRB liabilities,” and “[a]ccrued PRB liabilities are validated when they are recognized on the financial statements of companies.”

The Proposal Would Unfairly Limit Contractors’ Recovery of PRB Costs—In addition to setting a virtually insurmountable bar for accrual accounting, the measurement and assignment criteria in proposed CAS 419 would also unfairly limit contractors’ recovery of PRB costs whether accrual or PAYG accounting is used.

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The Proposal Would Require Contractors to “Draw Down” Previously Accrued PRB Costs: Given the stringent criteria for accrual accounting, the proposal would require many contractors that have implemented accrual accounting under FAR 31.205-6(o) to revert back to PAYG accounting. Proposed CAS 9904.419-64(b) would require these contractors to charge PRB costs calculated on the PAYG method against the fair value of plan assets and accumulated value of unfunded accruals before such costs could be allocated to intermediate or final cost objectives. 65 Fed. Reg. at 59546. Hence, not only does the proposal try to avoid the Government’s obligation to pay for the full cost of goods and services on an ongoing basis, it also seeks to recover part of the Government’s payment for previously provided goods and services.

The Proposal Would Require Amortization of Pre-Funded Payments: The proposal also would delay recognition of certain PRB costs that a contractor actually funds in the current accounting period. For plans using the PAYG method, proposed CAS 9904.419-50(b)(1) would require the amortization over 15 years of any nonmaterial amount “paid to irrevocably settle an obligation for post-retirement benefits payable in current and future cost accounting periods.” 65 Fed. Reg. at 59530. The proposed transition provisions would recognize a limited exception to this requirement for contractors that have established, disclosed, and consistently followed a practice of determining and funding PRB costs in accordance with CAS 9904.416-50(a)(1)(v)(C). See 65 Fed. Reg. at 59546 (proposed CAS 9904.419-64(d)).

For defined-contribution plans using accrual accounting, proposed CAS 9904.419-40(b)(4) would limit the assignable cost to the amount of the contribution required by the written provisions of the PRB plan (65 Fed. Reg. at 59529); any pre-retirement accrual of contributions expected to be made after retirement would not be recognized until the contribution was required to be made. 65 Fed. Reg. at 59507.

The Proposal Would Preclude Full Recognition of Accrued PRB Costs: Even contractors that are able to meet the stringent criteria for accrual accounting will almost certainly be unable to recover the full value of their accrued PRB costs. First, as noted above, proposed CAS 9904.419-

40(b)(5)(iii) would impose a ceiling on accrual cost recognition equal to the benefits paid during the period plus the unfunded nonforfeitable PRB obligation. Second, the proposal would limit recovery to the SFAS 106 delayed recognition method. Third, under proposed CAS 9904.419-50(b)(2)(ii), PRB costs would be limited to those benefits required by the written provisions of the PRB plan rather than by the “substantive plan” under SFAS 106 (i.e., the substance of the employer’s commitment to provide future benefits). Fourth, and perhaps most significantly, notwithstanding the Board’s recognition that retiree medical costs are growing at a much faster rate than inflation, proposed CAS 9904.419-50(b)(2)(iii) arbitrarily limits the assumed health care trend rate to the expected long-term rate of return on plan assets or, in the absence of an assumption about the long-term rate of return on plan assets, the interest rate determined by the Secretary of the Treasury pursuant to Public Law 92-41.

The Proposed “Segment Closing” Adjustment Provisions are Particularly Inequitable: Among the most inequitable provisions in the ANPRM is the coverage of segment closings. The CAS Board’s prefatory comments acknowledge that “[b]oth contractor and Government commenters generally preferred amendments to the pension Standards, CAS 9904.412 and 9904.413...rather than the promulgation of a new Standard,” because commenters were concerned “that a new Standard might be conceptually different from the current pension and insurance Standards.” 65 Fed. Reg. at 59512. The Board goes on to explain why it is necessary to promulgate a new Standard, but fails to address the commenters’ well-founded fear that the proposed new Standard would differ conceptually from the pension and insurance Standards.

CAS 9904.413-50(c)(12) requires a current period adjustment of previously-determined pension costs whenever a segment is closed, a pension plan is terminated, or pension benefits are curtailed. The Government’s “share” of the so-called segment-closing adjustment is measured by the percentage

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of CAS-covered contracts during a period representing the Government's participation in the pension plan, and "[t]he full amount of the Government's share...is allocable, without limit, as a credit or charge during the cost accounting period in which the event occurred and contract prices/costs will be adjusted accordingly." CAS 9904.413-50(c)(12)(vi) and (vii). By contrast, under proposed CAS 9904.419-40(f)(1) and 9904.419-50(f)(1), there would be *no adjustment* in the event of a segment closing for contractors using the PAYG method, as almost all contractors would under the proposed rule. 65 Fed. Reg. at 59525, 59532. Rather, under proposed CAS 9904.419-50(f)(1)(ii), PRB costs for inactive participants left "homeless" when a segment discontinues operations, is sold, or ownership is otherwise transferred, would be moved to the closed segment's immediate home office and allocated to the contractor's other contracts. 65 Fed. Reg. at 59532.

For defined-benefit plans using accrual accounting, the segment closing amount would be measured under proposed CAS 9904.419-50(f)(3)(i) as the difference between the *nonforfeitable* (i.e., vested) PRB obligation and the valuation assets, measured only during a period reflective of the "Government's historical participation in post-retirement benefit cost *from the time this proposed Standard first becomes applicable.*" 65 Fed. Reg. at 59513 (emphasis added). In other words, while CAS 9904.413-50(c)(12) purportedly allows the Government to measure its "share" of surplus *pension* assets using costs allocated to fixed-price contracts awarded long *before* the amendments took effect, the Government's obligation to pay for unfunded *PRB liabilities* would be limited to nonforfeitable obligations accrued *after* the new Standard takes effect or, for contractors that continue accruing costs under FAR 31.205-6(o), from the date such accrual began. Hence, as proposed Illustration 9904.419-60(f)(1)(ii) makes clear, even a contractor with a significantly *underfunded* PRB plan could still *owe* the Government a segment-closing credit if the valuation assets exceed this limited, nonforfeitable PRB obligation. Consequently, just as would be true for PRB obligations accounted for under the PAYG method, the ANPRM would permit the Government to walk away from its obligation to pay for non-vested liabilities under a defined-benefit PRB plan using accrual accounting. Addition-

ally, just as for PAYG plans, proposed CAS 9904.419-40(f)(3)(iii) provides that the costs of the remaining inactive participants would be transferred to the closed segment's immediate home office to be allocated to the contractor's other contracts. Notably, however, for defined-contribution plans, proposed CAS 9904.419-50(f)(2) requires an immediate period "adjustment to contract price or cost or by other suitable techniques" for the full amount of *unrecognized forfeiture credits* "because there will be no Government contracts in future periods to absorb a share of the credit." 65 Fed. Reg. at 59510.

Finally, to add insult to injury, the proposal fails to definitively require offsetting of the segment closing adjustment under proposed CAS 9904.419 against the segment closing adjustment under CAS 9904.413, lamely asserting that:

The proposed Standard does not address the offsetting of a post-retirement benefit segment closing adjustment against any pension segment closing adjustment. The Board believes that CAS 9904.413 determines the plan termination and segment closing adjustment for pension plans and this proposed Standard would determine the adjustment for post-retirement benefit plans. How either adjustment is actually transacted or effected is best determined by the contracting parties. This proposed Standard and CAS 9904.413 neither require nor preclude aggregation of these adjustments with each other or other issues for resolution and settlement purposes. 65 Fed. Reg. at 59514.

A September 1996 Staff Discussion Paper on this topic at least acknowledged that it was equitable and appropriate to offset underfunded PRB liabilities against any Government claim for surplus pension assets under CAS 9904.413-50(c)(12). As the Staff Discussion Paper observed:

When a segment closes, any adjustment amount measured for post-retirement benefit plans is to be reported to the parties for consideration when negotiating the overall settlement of costs and credits associated with the segment closing. The parties are expected to negotiate an agreement on the treatment of any post-retirement benefit segment closing adjustment and the CAS

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9904.413-50(c)(12) pension adjustment that is equitable based on the facts and circumstances of the particular segment closing. 61 Fed. Reg. at 49550.

The same service by an employee that produces a pension benefit obligation also can produce a post-retirement benefit obligation. Indeed, both pension and post-retirement benefits are earned by the same workforce working on the same Government contracts. No principled reason exists for the CAS Board to require different accounting treatments for adjusting previously-determined PRB costs and previously-determined pension costs. Nor is it equitable for the Government to demand a refund of surplus pension assets without also recognizing its obligation to pay for unfunded post-retirement benefits. Basing accounting standards on the identity of the party expected to write the check is not only contrary to sound accounting, it seriously calls into question the Board's independence.

The Proposal Creates a Potential Conflict with FAR 31.205-6(o)(3)—Under proposed CAS 9904.419-40(a)(1), accrual accounting would be mandatory for any PRB plan that meets the stated criteria. Moreover, proposed CAS 9904.419-40(b)(1) provides that “[e]xcept for costs assigned to future periods by 9904.419-40(b)(5)(iii) [because they exceed the assignable post-retirement benefit cost limitation], the amount of post-retirement benefit cost determined for a cost accounting period is assignable only to that period.” 65 Fed. Reg. at 59528. This provision could create a conflict with FAR 31.205-6(o)(3), which provides that: “To be allowable, [PRB] costs must be funded by the time set for filing the Federal income tax return or any extension thereof. PRB costs assigned to the current year, but not funded or otherwise liquidated by the tax return time, shall not be allowed in any subsequent year.” As noted, because of the adverse tax consequences, many contractors are, as a practical matter, unable to fund their PRB plans. Although the proposed rule laudably rejects funding as a mandatory criteria for accrual accounting, it creates—but fails to resolve—a conflict with the FAR funding requirement for contractors that would be required by the proposed Standard to use accrual accounting but have no tax-effective means of funding. The net result for such con-

tractors (and their employees) would either be to suffer the adverse tax consequences or to forgo recovery of accrued PRB costs under their Government contracts.

Conclusion—In summary, the proposed rule is contrary to sound accounting and the CAS Board's stated objectives of fairness and equity. The Board's Statement of Objectives, Policies and Concepts asserts that the Board “considers a Cost Accounting Standard to be fair when in the Board's best judgment it provides equitable allocation of costs to contracts and shows neither bias nor prejudice to either party to affected contracts.” 57 Fed. Reg. at 31036. The proposed rule fails to meet this criteria. Regrettably, just as happened with the controversial amendments to CAS 9904.413, the proposal on PRB accounting is likely to add credence to the view that the CAS Board is not independent and that its promulgations are improperly influenced by procurement policy (i.e., cost allowability) considerations rather sound accounting principles.



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