

By
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The Department of Defense (DoD) has argued that funding of Post-Retirement Benefits (PRBs) is necessary to protect the government against paying costs for PRBs in situations when contractors will ultimately fail to provide those PRBs to their employees. The issue of funding (i.e. making advance payments for these benefits through insurers, providers, or trustees) has come up because of rulemaking by the Cost Accounting Standards Board, which is seeking comments on whether funding should be required as a condition for accrual accounting. Contrary to DoD's argument, funding is not a shield to protect the government against unscrupulous contractors, but rather a sword DoD is wielding in an unseemly attempt to avoid the government's contractual obligation to pay for past service PRB costs.

Background

PRBs are defined by the Federal Acquisition Regulation (FAR) as "all benefits, other than cash benefits and life insurance benefits paid by pension plans, provided to employees, their beneficiaries, and covered dependents during the period following the employee's retirement." This includes, but is not limited to "postretirement health care; life insurance provided outside a pension plan; and other welfare benefits such as tuition

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assistance, legal services, day care, and housing subsidies provided after retirement." (FAR 31.205-6(o)(1).)

Until 1990, generally accepted accounting principles (GAAP) allowed employers to account for PRB costs on a "pay-as-you-go" basis, meaning that costs were recognized and paid when the benefits were actually provided. However, that situation changed in December 1990, when the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (FAS) 106, which required companies to recognize and accrue charges for PRBs for financial reporting purposes.

For most companies, FAS 106 became effective in the fiscal year that began after December 15, 1992. It meant that periodic PRB costs had to be recognized and reported over the working lives of employees earning PRBs, so that an employer's obligation for each employee's PRB would be fully accrued by the time the employee attained full eligibility. Because most employers had not previously accrued PRB costs, FAS 106 allowed companies to choose one of two options for recognizing the transition obligation (i.e. the accumulated PRB obligation for retirees and the PRB obligation for active employees effective for the period before FAS 106 was implemented). Employers had the choice of (1) immediately recognizing the transition obligation ("immediate recognition"), or (2) recognizing the obligation on a delayed basis over the period of future service for a particular plan but not for more than 20 years ("delayed recognition"). (FAS 106 ¶¶ 112, 113.)

In June 1991, a new subparagraph was added to the FAR cost principle on compensation for personal services that made PRB past service costs as defined by FAS 106 allowable. (FAR 31.205-6(o).) At first, the cost principle did not limit the amount of allowable PRB costs that could be assigned to a single fiscal year. However, in

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August 1991, the interim rule was amended to limit recognition of PRB past service costs to those computed under the FAS 106 “delayed recognition” methodology, regardless of how a contractor actually accounted for them. Then, in December 1994, FAR 31.205-6(o) was further amended to add a third way to recognize these costs—terminal funding.

Now, FAR 31.205-6(o) provides that to be allowable, PRB costs must be reasonable and incurred pursuant to law, an employer-employee agreement, or an established policy of the contractor. In addition, the costs must be calculated using one of the following three methods:

- **Cash Basis.** Costs are not recognized until the benefits are actually provided, and “must be paid to an insurer, provider, or other recipient for current year’s benefits or premium.”
- **Terminal Funding.** The entire PRB liability is accrued and paid in a lump sum to an insurer or trustee when the employee’s employment has ended. The lump sum amount is allowable if amortized over a period of 15 years.
- **Accrual Basis.** Costs must be measured and assigned in accordance with GAAP (e.g., FAS 106) and generally accepted actuarial principles and practices as promulgated by the Actuarial Standards Board, and “be paid to an insurer or trustee to establish and maintain a fund or reserve for the sole purpose of providing PRB to retirees.” Under the accrual basis, PRB costs attributable to past service are allowable only up to the amount computed under the FAS 106 “delayed recognition” methodology. (FAR 31.205-6(o)(2), (5).)

Hence, although FAS 106 requires the accrual basis for financial reporting, a company could use the cash method or terminal funding for government contracting purposes. Notably, however, FAR 31.205-6(o), unlike FAS 106, requires that PRB costs be “funded” to be allowable. (FAR 31.205-6(o)(2), (3).) Moreover, PRB costs assigned to a current year, but not funded or otherwise liquidated by tax return time are expressly unallowable, according to FAR 31.205-6(o)(3).

A number of ways exist to “fund” PRB costs. Under the cash basis and terminal funding methods, companies typically make cash payments to an insurer, provider, or beneficiary, or to a trustee. Companies using the accrual method also make cash payments to an insurer or trustee, or they can establish and make

contributions to a Voluntary Employee Benefit Association account. They also can fund PRB costs using surplus pension assets, which the Internal Revenue Service has said can be used to pay annual post-retirement health care costs. (26 U.S.C. § 420.)

Until recently, a provision at FAR 31.205-6(j) provided that in the absence of an advance agreement, transferring pension assets to another employee benefit plan fund (such as using surplus pension assets to “fund” PRB costs) would be treated as a “constructive withdrawal and receipt” of those pension assets, triggering a government claim for an “equitable share” of the assets that were transferred. However, a FAR amendment that took effect December 29, 1998, now provides that a government claim is triggered only upon termination of the pension plan or other constructive receipt of pension assets. On the other hand, pension costs that increase because of a transfer without an advance agreement are still unallowable. Therefore, while using surplus pension assets to fund PRB costs without an advance agreement may ultimately reduce the amount of pension costs that can be charged to the government, this action should not give rise to an affirmative government claim against a contractor.

Government Liability for Past-Service PRB Costs

During the 1980’s, the defined benefit pension plans maintained by many government contractors accumulated large surpluses. In 1989, the government began a regulatory campaign to recover what it viewed as its “equitable share” of the surplus funds by modifying both the FAR cost principles and related clauses and Cost Accounting Standards (CAS) 412 and 413. (See, e.g., FAR 31.201-5; FAR 31.205-6(j)(3)(v), (j)(4); FAR 52.215-15; 48 C.F.R. §9904.413-50(c)(12).) While eager to share in those surplus pension assets, the government has not been similarly forthcoming in agreeing to shoulder its “equitable share” of past-service PRB costs.

In fact, DoD has argued that based on unspecified “policy reasons,” contractors should not be reimbursed for future PRB liabilities not funded and that “any settlement adjustment to account for differences between fund assets and liabilities should apply only to the years during which the contractor made estimated fund contributions.” (Letter from Assistant Inspector General Policy and Oversight to Executive Secretary, Cost Accounting Standards Board (CASB) (March 15, 1999).) Similarly, the Department of the Army and

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Defense Contract Audit Agency (DCAA) have taken the position that, once an Army Ammunition Plant (AAP) contract ended, the 1991 amendments to FAR 31.205-6(o) relieved the government of liability for any accrued PRB liabilities not funded. (See Memorandum from Brigadier General Joseph W. Arbuckle, Deputy for Ammunition, Department of the Army Office of the Assistant Secretary, Research Development and Acquisition to Commander, U.S. Army Industrial Operations Command (July 10, 1996).)

Because the FAR requires contractors to amortize past-service costs over the FAS 106 “delayed recognition” period, which is considerably longer than the term of a typical AAP contract, the Army/DCAA position means that a large percentage of the past-service PRB costs would never be recognized. Even under a government-owned-contractor-operated (GOCO) contract, which usually includes a provision rolling forward unreimbursed costs of performing previous GOCO contracts to succeeding GOCO contract(s), application of the Army/DCAA position would result in the non-recognition of PRB costs except in cases where the same contractor holds the contracts until costs are fully amortized. In some cases, DCAA has even taken the position that the “government’s share” of pension adjustments required by CAS 413-50(c)(12) and FAR 31.205-6(j)(4) should not be reduced by the amount of accrued, unfunded PRB liabilities, even though the pension benefits and PRBs are for the same workforce.

Fortunately, there is no case law or other authority to support the DoD position and considerable reason to question its legitimacy, particularly with respect to GOCO contracts. Under the “Allowable Cost and Payment” clause, a standard clause used in all cost reimbursement contracts (and similar clauses for other flexibly priced contracts), the government agrees to pay the contractor for all costs determined allowable under the terms of the contract and under the cost principles in effect when a contract is awarded. (FAR 52.216-7.) Upon final payment, the clause requires the contractor to sign a release, discharging the government – with three notable exceptions – from further liabilities under the contract. (FAR 52.216-7(h).)

The three exceptions are for: (1) known, specified claims, (2) unknown claims based on third-party liabilities of the contractor arising from contract performance (with written notice within 6 years), and (3) claims for reimbursement of costs incurred under the contract’s patent clauses. Therefore, PRB costs could be excepted from final release as known or unknown claims, which

means the government would continue to be liable to reimburse costs even after the contract ends. For GOCO contracts, with their unique “roll forward” provision, the contractor’s argument for compensation for PRB costs is even more compelling.

CAS may also provide a basis for a PRB adjustment after the contract ends. Although no CAS provision addresses PRBs solely, these benefits have been treated as an integral part of a pension plan subject to CAS 412 and CAS 413 and as insurance costs subject to CAS 416. Under either standard, the contractor should be entitled to a PRB adjustment when a segment closes. According to the preamble of CAS 416, the application of either CAS 412 or CAS 416 is intended to “result in substantially the same amounts of allocable cost.” CAS 412-50(a)(7) provides that:

If a pension plan is supplemented by a separately funded plan which provides retirement benefits to all of the participants in the basic plan, the two plans shall be considered as a single plan for the purpose of this Standard. If the effect of the combined plans is to provide defined-benefits for the plan participants, the combined plans shall be treated as a defined-benefit plan for purposes of this Standard.

CAS 413-50(c)(12) applies when a contractor has (a) sold or transferred ownership of a segment, (b) discontinued operations, or (c) discontinued, or is no longer actively seeking, government business under CAS 413 contracts. It requires computation of a “government’s share” of surplus *or deficit* pension assets – including PRBs treated as part of the pension plan under CAS 412-50(a)(7) – that is to be allocated as a credit or charge in the current cost accounting period. Similarly, CAS 416-50(a)(1)(v)(c) requires that funding be apportioned over the working lives of active employees, and when the segment closes, the “working lives” period ends. Arguably, therefore, a segment closing adjustment is appropriate under CAS 416 to recognize and fund the remaining balance of the accumulated PRB liability.

The Bogus Funding Controversy

In September 1996, the CASB staff published a Staff Discussion Paper entitled, “Cost Accounting Standard Relating to the Treatment of Costs of Post-Retirement Benefit Plans other than Pension Plans Sponsored by Government Contractors.” (See 61 Fed. Reg. 49534, 49550 (Sep. 20, 1996).) Ominously, the paper questioned

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whether the government has any responsibility for contractors' unfunded accumulated PRB liability and whether there should be a segment closing adjustment for PRBs – like the segment closing adjustment provision added to CAS 413-50(c)(12) in March 1995. In response to the Staff Discussion Paper, DoD commenters, including then Under Secretary of Defense (Acquisition and Technology) Paul Kaminski, argued that funding was necessary to prevent contractor windfalls in situations where the contractor could unilaterally avoid PRB liability after the government reimbursed the costs.

By letter dated January 12, 1999, the CASB invited comments from interested parties on the validity or “compellability” of post-retirement benefit obligations as a prerequisite for accrual accounting and the need, if any, to “substantiate” accruals by funding. Interestingly, DoD submitted comments both favoring and opposing the addition of a funding requirement by the CASB. In direct contrast to the position expressed by Paul Kaminski, the Deputy Director of Defense Procurement for Cost, Pricing, and Finance Carol Covey said in a March 12, 1999 letter that funding was solely a “procurement policy decision.” She also said that while “it is appropriate to continue to include the funding requirement in the FAR, it should not be added to the CAS.” (Letter from Deputy Director of Defense Procurement (Cost, Pricing, & Finance) to Cost Accounting Standards Board (March 12, 1999).) However, Covey’s letter goes on to say that:

Contractor funding is necessary to prevent contractor windfalls in situations where the Government pays for the cost of the benefits but the contractor ultimately declines to pay these benefits. Contractor funding is especially critical for PRBs due to the dollar magnitude of the costs, the extended delay between employment service and the benefit payment that liquidates liability, and the uncertainty surrounding the ultimate payment of the liability. (*Id.*)

On the other hand, comments by DoD Assistant Inspector General (IG), Policy and Oversight Robert Lieberman argued that the CASB *should* impose a funding requirement. (Letter from Assistant Inspector General Policy and Oversight to Executive Secretary, Cost Accounting Standards Board (March 15, 1999).) Interestingly, the IG’s comments assert that “[c]urrently, neither CAS nor FAR 31.205-6(o)(6) require funding of PRB costs,” because “[t]he FAR provides contractors with an option to either fund or *otherwise liquidate* accrued postretirement benefits.” (*Id.* at 1 (emphasis in original).)

Although acknowledging that “funding does not prove the validity of a liability,” the IG also illogically asserts that “[u]nless funding is required, the government risks reimbursing contractors for liabilities that may never be liquidated.” (*Id.*) Furthermore, the IG concludes by observing that “[w]hen contractors sell business segments, discontinue operations, or abolish benefit plans, the government could be asked to reimburse contractors for past PRB costs although the contractor primarily operated on a cash basis prior to the event,” and urging the CASB to limit any “settlement adjustment” to “cost accounting periods in which funding occurred.” (*Id.* at 4.)

As the IG’s comments make clear, a funding requirement on top of the CASB’s adoption of FAS 106 could have a pernicious and unfair effect on contractors because PRB obligations previously accrued would not be recognized. This is contrary to the CASB’s stated objective of fairness and equity and would likely result in disputes and litigation.

The 1996 CASB Staff Discussion Paper noted two factors that determine whether a PRB is a cost: compellability and measurability. (61 Fed. Reg. 49534, 49540 (Sep. 20, 1996).) Contrary to DoD’s specious assertions, funding does not make a post-retirement benefit any more compellable. As the IG observes, funding may mean funds more likely will be available to pay costs when they become due and a contractor is therefore less likely to default on obligations. However, the underlying obligation either exists or it does not, regardless of whether or not the contractor prepays the costs of meeting that obligation. In other words, the fact that one prepays a cost does not make the cost any more valid. Therefore, contrary to DoD’s comments, funding does not “substantiate” the accrual of post-retirement benefit costs.

Whether a PRB is compellable is a matter of employment law and the contractual agreement between the employer and his employees. Under the FAR, PRBs, like any other element of personal compensation, are considered “costs” when they are required by law, by employer-employee agreement, or by an established policy of the contractor that implies an agreement to provide the benefit. (FAR 31.205-6(a)(3), (o)(2).) Similarly, FAS 106 requires recognition of PRBs based on a “substantive plan” that reflects an employer/employee agreement to provide those benefits in exchange for employees’ service. Although some companies, in an abundance of caution, may downplay

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the legal enforceability of their PRB plans (such as the footnote to General Motors' 1993 financial statement cited by the CASB letter), the CASB has not presented evidence to suggest that contractors have failed or refused to satisfy their PRB obligations. Absent such evidence, there is no principled reason for distinguishing PRBs from other elements of personal compensation. Even if the CASB had evidence to suggest that contractors were failing to pay promised benefits, the compellability of PRB obligations could be sufficiently demonstrated by a written employer-employee agreement that contains an enforceable promise to provide at least a minimum level of benefits. When companies make unilateral changes to their PRBs, they generally do not terminate the plans or materially reduce the overall dollar value of the benefits. Rather, companies make changes designed to contain costs. For example, as the cost of providing health care benefits increases, companies may increase beneficiaries' co-payment obligations to offset increased costs. The government is not harmed when companies make these types of changes because the cost to the company remains unchanged; therefore the government pays no more or less than it should have for the cost.

Measurability also is not a sufficient reason for the CASB to question the validity of post-retirement benefit costs. As the FASB aptly observed in promulgating FAS 106, "measuring the net periodic post-retirement benefit cost and accumulated post-retirement benefit obligation based on best estimates is superior to implying, by a failure to accrue, that no cost or obligation exists prior to the payment of benefits." (FAS 106, at ¶ 29.) The government's interests are adequately protected by prescribing that PRBs be measured in accordance with Actuarial Standards of Practice. These require that each of the actuarial assumptions independently represent the actuary's best estimate of experience under the plan. Because PRBs are accrued over many years, these measurements are self-correcting because future years will take into account actuarial gains and losses.

The real risk to both the government and the contractor arises when there are no longer any future accounting periods to make these self-correcting adjustments. That risk could be mitigated by a segment-closing provision analogous to that found in CAS 413-50(c)(12). However, because the CASB lacks statutory authority to adjust the price of fixed-price contracts in the absence of a change to cost accounting practices or noncompliance, any closing provision should be limited to a *cost* adjustment. In the interest of fairness, the CASB also should adopt a provision affirmatively *requiring* that

PRB costs be considered in making the adjustment required by CAS 413-50(c)(12). The very same service that produces a pension benefit obligation also produces a PRB obligation. Indeed, in many cases, both pension amounts and PRBs are earned by the same workforce working on the same government contracts. There is no principled reason for the CASB to require a different accounting treatment for adjustments for previously determined pension costs – which generally are funded – than adjustments for previously determined PRBs – which generally are unfunded. Nor is it equitable for the government to demand a refund of costs for pension assets that revert to the contractor without also recognizing its obligation to pay for unfunded PRBs. Although refunds and payments are beyond the scope of the CASB's authority, the accounting treatment should at least be the same.

Procurement policy aside, imposition of a funding requirement as a prerequisite for accrual accounting is simply bad accounting. Sound accounting generally requires the matching of costs to benefiting cost objectives. As the CASB recognized in its Statement of Objectives, Policies and Concepts, "[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 (Jul. 13, 1992), *reprinted in* Cost Accounting Standards Guide (CCH), ¶ 3280, at 4204.). Accrual — not cash — accounting provides the best matching of costs to benefiting cost objectives. Imposition of a funding requirement effectively forces the use of cash accounting as a condition for use of accrual accounting. Imposition of a funding requirement also would be contrary to the goal of enhancing uniformity and consistency in accounting for contract costs. Because FAS 106 requires accrual accounting, whether or not the company pre-funds the liability, imposition of a funding requirement would be contrary to generally accepted accounting principles and would require contractors to maintain two sets of accounting records.

Conclusion

In summary, DoD's reasons for imposing a funding requirement are illogical and contrary to sound accounting. If the real objective is to limit or avoid the government's obligation for past service PRB liabilities, DoD should at least have the intellectual honesty to say so. In any event, however, both as a matter of sound accounting and principled rulemaking, the CASB should reject DoD's bogus arguments.