VIA HAND DELIVERY

Mr. Eric Shipley
Project Director
Cost Accounting Standards Board
Office of Federal Procurement Policy
Room 9013
725 17th Street, N.W.
Washington, D.C. 20503

Re: CASB Docket No. 96-02A, Accounting for the Costs of Post-Retirement Benefit Plans Sponsored by Government Contractors,
65 Fed. Reg. 59504 (October 5, 2000)

December 18, 2000

Dear Mr. Shipley:

On behalf of the Section of Public Contract Law of the American Bar Association (the “Section”), I am submitting comments on the above-referenced matter. The Section consists of attorneys and associated professionals in private practice, industry, and Government service. The Section’s governing Council and substantive committees contain members representing these three segments to ensure that all points of view are considered. In this manner, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.

The Section is authorized to submit comments on acquisition regulations under special authority granted by the Association’s Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.

I. Introduction

The Section recognizes that the issue of accounting for post-retirement benefits is an intrinsically complex and technical subject. Nevertheless, we are concerned that the proposed Standard, which spans twenty-two pages in the Federal Register, is unnecessarily long, complicated, and difficult to understand. Accrual accounting, following the provisions of the Financial Accounting Standards Board’s Statement No. 106, “Employers’ Accounting for Post-Retirement Benefits Other Than Pensions” (SFAS 106), provides an appropriate, streamlined, and uniform basis for measuring and assigning the costs of post-retirement benefit plans. The proposed modifications and restrictions on the application of SFAS 106 needlessly complicate the proposed Standard and would distort contract cost recognition.

The proposed modifications and restrictions are also unnecessary to protect the Government’s interests in the event of a segment closing, plan termination, or curtailment of benefits. The Government’s interests in those circumstances can adequately be protected through the incorporation of a contract clause, such as the existing “Reversion or Adjustment of Plans for Postretirement Benefits (PRB) Other than Pension” clause found at section 52.215-18 of the Federal Acquisition Regulation (“FAR”), or through a segment-closing adjustment analogous to the provision at Cost Accounting Standard 9904.413-50(c)(12).

II. The “Bar” For Accrual Accounting Is Set Too High.
As a matter of good cost accounting practice, the measurement, assignment, and allocation of post-retirement benefit costs should be based on the beneficial or causal relationship between those costs and the benefiting cost objectives. Recognizing the costs of post-retirement benefits ratably over the working lives of the employees earning the benefits provides the best matching of post-retirement benefit costs to the benefiting contract activity, thus enhancing predictability, consistency, and uniformity. This was clearly recognized in paragraph 3 of SFAS 106, which states that:

The Board views a postretirement benefit plan as a deferred compensation arrangement whereby an employer promises to exchange future benefits for employees’ current services. Because the obligation to provide benefits arises as employees render services necessary to earn benefits pursuant to the terms of the plan, the Board believes that the cost of providing benefits should be recognized over those employee service periods.

Although recognizing these accounting principles, the proposed Standard establishes criteria that would make it virtually impossible to accrue post-retirement benefit costs over the working lives of employees earning the benefits.

A. The Proposed Standard Properly Rejects “Funding” As A Criterion For Accrual Accounting.

The Section agrees with the Board’s decision to eliminate funding as a criterion for accrual accounting. As the September 1996 Staff Discussion Paper observed, there are two aspects to determining whether a post-retirement benefit is a cost: compellability and measurability. See 61 Fed. Reg. 49534, at 49540 (Sep. 20, 1996). Funding does not make a post-retirement benefit any more compellable or measurable than it would otherwise be. Although funding may, as a practical matter, make it more likely that funds will be available to pay the costs when they become due, and therefore less likely that a contractor will default on its obligation, 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.

Whether a post-retirement benefit is compellable is a matter of employment law and the contractual relationship between employer and employee. 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.” A compellable obligation to pay post-retirement benefits can result from an employment contract, a collective bargaining agreement, an established pattern and practice of making the payments, a contractual agreement with the Government, or even the threat of civil action if the benefit is not paid.

Measurability is also not a sufficient reason to question the validity of post-retirement benefit costs. As the Financial Accounting Standards Board aptly observed in promulgating SFAS 106, “measuring the net periodic postretirement benefit cost and accumulated postretirement 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.” SFAS 106, ¶ 29. The Government’s interests are adequately protected by prescribing that post-retirement benefits be measured in accordance with Actuarial Standards of Practice, which require that each of the actuarial assumptions independently represent the actuary’s best estimate of experience under the plan. Moreover, because post-retirement benefits are accrued over many years, the measurement is self-correcting because measurements in future years will take into account actuarial gains and losses. A risk to both contracting parties arises when there are no longer any future accounting periods in which to make these self-correcting adjustments. As discussed below, that risk could and should be mitigated by a segment-closing provision analogous to that found in CAS 9904.413-50(c)(12).

B. “Vesting” Is An Inappropriate Measure For Recognizing Post-Retirement Benefit Costs.

Vesting, like funding, also is an inappropriate criterion for accrual accounting. As the September 1996 Staff Discussion Paper observed, the most common form of post-retirement benefit is retiree health care, which accounts for 80% of post-retirement benefit liabilities. See 61 FR 49533 (Sep. 20, 1996). Because most post-retirement benefit plans provide entitlement to a service, such as retiree medical care or reimbursement for the cost of obtaining that service, the actual amount of benefits paid will depend on the individual beneficiary’s health and longevity. In addition, unlike most pension plans, entitlement to post-retirement benefits often vests all at once upon retirement or upon meeting specified age and service requirements. Hence, unlike the cost of providing a defined pension benefit, which can be actuarially determined each year over the working life of an individual employee, it is not possible to similarly determine an annual post-retirement benefit cost over that same employee’s working life. For these reasons, vesting is an inappropriate measure...
for recognizing post-retirement benefit costs, because it will invariably delay and distort the recognition of post-retirement benefit costs.

Under the proposed Standard, costs of post-retirement benefit plans would be accounted for on an accrual basis if, but only if: (1) the promise of future benefits is communicated in writing to employees, including notice of the right to legally enforce payment; (2) participants have an irrevocable right to any portion of a benefit for which they have become eligible; (3) 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; (4) the annual cost for a defined-contribution PRB plan is the contribution required by the written provisions of the plan; and (5) the annual cost of a defined-benefit PRB plan is actuarially determined based on the written provisions of the plan. See 65 Fed. Reg. at 59528 (proposed CAS 9904.419-40(a)(1)).

Nevertheless, even if the plan meets these criteria, the proposed Standard would still limit post-retirement benefit costs assigned to a cost accounting period to the sum of (1) the post-retirement benefits paid for the period (i.e., the pay-as-you-go amount) and (2) the unfunded, nonforfeitable post-retirement benefit obligation.

The nonforfeitable post-retirement benefit obligation is defined by proposed CAS 9904.419-30(a)(7) 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 post-retirement benefit obligation is “[t]he excess, if any, of the nonforfeitable post-retirement benefit obligation, including benefit eligibility as of the last day of the plan year, over the valuation assets.” Hence, because post-retirement benefits generally vest at retirement or upon attaining the specified age and service levels necessary for retirement, the practical effect of the proposed Standard is that no post-retirement benefit costs would be recognized for government contract purposes until the employee is eligible to retire.

The proposed criteria and assignment limitations go well beyond what is reasonably necessary to ensure that a post-retirement benefit is a valid liability. They are also inconsistent with the other compensation Standards, such as CAS 9904.408, 9904.412, 9904.413, and 9904.415, none of which requires that benefits be fully vested before they are recognized for government cost accounting purposes. The Government’s interests are sufficiently protected with a requirement for compellability (determined through any of the various means discussed above), rather than non-forfeitality, coupled with a reversionary interest in forfeiture credits.

III. The Proposed Standard Is Inequitable.

It appears that the proposed Standard seeks to avoid or reduce the Government’s obligation, which is contrary to the Board’s stated objectives and principles. Part of the problem is that the proposed Standard is designed around the exception (e.g., contractor bankruptcies, contractor plan terminations, “gaming” the system) rather than the rule. There are better means of protecting the Government’s interests in these special situations. The Standard should focus on the general case and not sacrifice good accounting simply because of the occasional “bad apple.” Moreover, the rule should be evenhanded and focus on good accounting, not procurement policy. Consistent with the Board’s Statement of Objectives, Policies and Concepts, “a Cost Accounting Standard [is] 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. 31036 (Jul. 13, 1992), reprinted in CCH COST ACCOUNTING STANDARDS GUIDE ¶ 3280, at 4203.

Given the stringent criteria for accrual accounting, the proposed Standard would require many contractors who have implemented accrual accounting under FAR 31.205-6(o) to revert back to pay-as-you-go accounting. Proposed CAS 9904.419-64(b) would require these contractors to charge post-retirement benefit costs calculated on the pay-as-you-go 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. See 65 Fed. Reg. at 59546. The proposed Standard would also delay recognition of certain post-retirement benefit costs that a contractor actually funds in the current accounting period. For plans using the pay-as-you-go method, proposed CAS 9904.419-50(b)(1) would require the amortization over fifteen years of any non-material amount “paid to irrevocably settle an obligation for post-retirement benefits payable in current and future cost accounting periods.” Id. at 59530. In addition, 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 post-retirement benefit plan, and any pre-retirement accrual of contributions expected to be made after retirement would not be recognized until the contribution was required to be made. Id. at 59507.
Even contractors able to meet the stringent criteria for accrual accounting would almost certainly not be able to recover the full amount of their accrued post-retirement benefit 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 post-retirement benefit obligation. Id. at 59529. Second, the proposed Standard would limit recovery to the delayed recognition method of SFAS 106. Id. at 59508. Third, under proposed CAS 9904.419-50(b)(2)(ii), post-retirement benefit 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. Id. at 59530. Fourth, and perhaps most significantly, notwithstanding the Board’s recognition that medical costs are growing at a much faster rate than inflation, proposed CAS 9904.419-50(b)(2)(iii) would arbitrarily limit 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. Id.

Most inequitable – particularly in light of the 1995 amendments to CAS 9904.413-50(c)(12) – are the proposed adjustments for segment closings. The proposed Standard’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.” 65 Fed. Reg. at 59512. The prefatory comments also expressly recognize that the commenters’ concerns “appear to be driven by fears that a new Standard might be conceptually different from the current pension and insurance Standards.” Id. Although the Board has explained why it promulgated a new Standard, it has failed to address the commenters’ well-founded fear that the proposal is conceptually different from the pension and insurance Standards.

CAS 9904.413-50(c)(12) presently 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 of covered contracts subject to CAS 9904.413 during a period of years representative of 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.” See CAS 9904.413-50(c)(12)(vi), (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 pay-as-you-go method, as almost all contractors would under the proposed Standard. Rather, under proposed CAS 9904.419-50(f)(1)(ii), post-retirement benefit costs for inactive participants left “homeless” by the segment closing 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) post-retirement benefit 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.” Id. 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 post-retirement benefit liabilities would be limited to nonforfeitable obligations accrued after the new Standard takes effect, or, for contractors who continue accruing costs under FAR 31.2-5-6(o), from the date such accrual began.

A more equitable approach would be to use the Government’s participation in CAS-covered contracts during the years in which the obligations were accruing. 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. This is clearly inequitable.

In the interest of fairness, the Board should modify the proposed Standard to affirmatively require that post-retirement benefit costs be considered in making the adjustment required by CAS 9904.413-50(c)(12). Many negotiated segment closing adjustments under CAS 9904.413-50(c)(12) – both before and after CAS 9904.413 was amended in 1995 – expressly included offsets for unfunded post-retirement benefit costs. Typically, the very same service that produces a pension benefit obligation also produces a post-retirement benefit obligation. Indeed, in many cases, both pension and post-retirement benefits are earned by the very same workforce working on the very same Government contracts.

There is no principled reason to require a different accounting treatment in the adjustment of previously
determined pension costs (which generally are funded) than in making an adjustment of previously determined post-retirement benefit costs (which generally are unfunded or underfunded). 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 post-retirement benefits. Although refunds and payments are beyond the scope of the Board’s authority, the accounting treatment should at least be the same.


Under proposed CAS 9904.419-40(a)(1), accrual accounting would be mandatory for any post-retirement benefit 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 existing FAR 31.205-6(o)(3), which provides that: “To be allowable, [post-retirement benefit] 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.”

Because of the adverse tax consequences, many contractors are unable to fund their post-retirement benefit plans. Although the proposed Standard laudably rejects funding as a criterion for accrual accounting, it creates – but fails to resolve – a conflict with the FAR funding requirement for contractors who would be required by the proposed Standard to use accrual accounting but have no tax-effective means of funding. The net result would be that such contractors would either have to suffer the adverse tax consequences or forever forgo recovery of accrued PRB costs. The Administrator of the Office of Federal Procurement Policy should resolve this inconsistency in accordance with 41 U.S.C. § 422(j)(3).

V. Conclusion

In summary, the Section of Public Contract Law urges the Board to consider adopting SFAS 106 (excluding the proposed modifications and limitations) with a segment-closing adjustment provision analogous to that provided by CAS 9904.413-50(c)(12) as a more streamlined alternative to the currently proposed Standard. In addition, the Board should consider establishing a Government-industry working group to resolve these complex issues in a way that both sides would consider fair. Finally, the Section recommends that the Board hold a public hearing before issuing a notice of proposed rulemaking.

The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Very truly yours,

Gregory A. Smith
Chair

Enclosure: Diskette (MS Word)
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