On December 19, 1996, the Section submitted comments to the Cost Accounting Standards Board (Board) regarding treatment of costs of post-retirement benefit plans other than pension plans as set forth in the September 1996 staff discussion paper.

The Section offered several specific recommendations to improve the approach as set forth in the staff discussion paper on accounting for PRB costs. First, the Section recommended that the Board identify the types of PRB costs that are material in amount and confine the proposed coverage to material PRB costs. Second, the Section suggested that the Board determine whether existing CAS 412 and 413 coverage of PRB costs is adequate for PRBs that are part of a pension plan and for PRB plans that supplement a basic pension plan. Third, the Section recommended that the Board prepare rules for material PRB costs that are consistent with CAS rules governing similar costs, and adopt accrual accounting for PRB costs. Fourth, the Section recommended that the Board require funding of accrued PRB costs only if payment cannot be compelled or research discloses a significant incidence of contractors defaulting on their PRB obligations. Finally, the Section recommended that in the event of a segment closing or plan termination, the Board should adjust costs for unrealized assumptions, but should not adjust prices of fixed-priced type contracts or closed years of cost-type contracts.

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 a balance of 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.

On February 20, 1996, the Section submitted its written views on accounting for PRB costs preparatory to issuance of the Staff Discussion Paper. The Section's February 1996 submission articulated critical issues that the CAS Board must address in order to construct a cogent, well-thought-out accounting treatment for PRB costs. Because we do not perceive that the September 1996 Staff Discussion Paper adequately focuses on these critical issues, we summarize them below and urge the Board to give them renewed consideration.

- Identify the types of PRB costs that are material in amount and confine the proposed coverage to material PRB costs.
- Determine whether existing CAS 412 and 413 coverage of PRB costs is adequate for PRBs that are part of a pension plan and for PRB plans that supplement a basic pension plan.
- Prepare rules for material PRB costs that are consistent with CAS rules governing similar costs (e.g., pensions, insurance, deferred compensation).
- Adopt accrual accounting for PRB costs.
- Require funding of accrued PRB costs only if payment cannot be compelled, or research discloses a significant incidence of contractors defaulting on their PRB obligations.
- In the event of a segment closing or plan termination, adjust costs for unrealized assumptions, but do not adjust prices of fixed price type contracts or closed years of cost-type contracts.
- Consider accounting rules promulgated by other bodies (FASB, IRS, NAIC), but remember the CAS Board's unique mandate to ensure the accurate measurement, assignment, and allocation of contract costs.
- Avoid treating matters unrelated to cost accounting.

Certain of these points are discussed further below.

1. **Identify and limit coverage to PRB costs that are material in amount.** The original CAS Board, in developing CAS 412 and 413, and the Financial Accounting Standards Board ("FASB"), in developing Statement of Financial Accounting Standards No. 106 ("FAS 106"), found that the overwhelming majority of PRB costs relate to medical benefits. The Board in the Staff Discussion Paper notes that it has received information from actuaries that health care benefits account for 80 percent of PRB liabilities, life insurance accounts for another 19 percent, and all other forms of PRBs account for only 1-2 percent. If the Board's research bears this out, then the Board should confine its proposed PRB coverage to health care and life insurance benefits. The original CAS Board consistently maintained the position that it would not concern itself with immaterial items of cost, and this Board has not disagreed with that position. Immaterial PRB costs...
costs can be accounted for in many appropriate ways, for instance, as deferred compensation costs or on a pay-as-you-go basis.

2. Determine whether existing CAS 412 and 413 coverage is adequate for PRBs that are part of a pension plan and for PRB plans that supplement a basic pension plan. In its research relative to CAS 412, the original CAS Board noted that certain defined benefit pension plans included post-retirement benefits other than pensions (primarily medical benefits) as part of the basic plan, while other companies provided such post-retirement benefits under separate, supplemental plans. The Board concluded that the accounting for such benefits should be the same, in CAS 412.50(a)(9):

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 purposes of this Standard.

This provision was retained by the CAS Board in the newly revised CAS 412, renumbered as CAS 412-50(a)(7). The Board should use that coverage as its baseline for accounting for post-retirement medical benefits provided as part of, or as a supplement to, a basic defined benefit pension plan. Any departure from the coverage that currently exists should be supported by clear accounting rationale that explains the reasons why, from an accounting perspective, the current coverage is not appropriate.

3. Propose rules for material PRB costs that are consistent with CAS rules governing similar costs. For material PRBs that are not covered by CAS 412-50(a)(7) (i.e., separately provided life insurance benefits, or medical benefits provided apart from a defined benefit pension plan), the Board should similarly consider whether there is any accounting reason that these costs cannot be accounted for under current CAS rules, such as CAS 412/413 for health care benefits, and CAS 416 for life insurance.

While we do not necessarily advocate conforming health benefit PRB coverage to the current rules in CAS 412 and 413, we believe it would be prudent to begin with existing coverage as the baseline, and then make any changes to existing coverage that are deemed desirable from an accounting standpoint. With respect to the existing coverage in CAS 416-50(a)(1)(v) for life insurance on retired persons, the Section believes this coverage is adequate.

4. Adopt accrual accounting for PRB costs. Accrual accounting is, we believe, required by the CAS Board's statutory mandate to achieve uniformity and consistency in accounting for contract costs. Further, the Board's own May 1992 Statement of Objectives, Policies and Concepts states that accrual accounting generally provides the best matching of costs to the production of goods and services that give rise to those costs. The Standards themselves have consistently embraced accrual accounting for compensation costs -- see CAS 408, 412, and 415. These Standards require that costs be accrued in the accounting period in which the benefits are earned -- a principle which should be applied for consistency's sake to PRBs, which are generally earned over employees' working lives.

We believe that any difficulties that may be encountered in estimating on a present value basis the current liability for future PRB expense are not sufficient to abandon the fundamental principle of accrual accounting. The actuarial liability for PRB benefits has not been demonstrated to be significantly more difficult to determine than the liability for pension expense. Certainly, the FASB considered this issue and determined that some estimate of future expenditures was preferable to no estimate at all.

If the Board adopts an accrual accounting requirement for PRBs, we recognize that there will be in many cases a substantial, newly recognized cost (the "initial unfunded liability" or "transition obligation") consisting of PRBs that were earned in earlier cost accounting periods when the contractor accounted for PRBs on a cash basis. FAS 106 provides that the transition obligation may be immediately recognized, or may be amortized over a period of years. For government contract costing purposes, amortization would appear to be preferable to smooth out the impact of a change on affected contracts.

It is important for the CAS Board to make some provision for those contractors who, when they became subject to FAS 106, changed to accrual accounting for PRBs for government contracting accounting.
purposes as well. These contractors experienced a large transition obligation with no means for recovering an allocable share on government contracts because the change was considered voluntary. There is no equitable reason to distinguish between these contractors and those who will change to accrual accounting as a result of whatever action the Board takes in this area. One possible mechanism for dealing with this inequity is to henceforth require accrual accounting for health benefit and life insurance PRBs (pursuant to CAS 412 and 416), while deeming changes to accrual accounting for PRBs prior to the effective date of the requirement to be "desirable" changes.

5. **Require funding of PRB costs only if payment cannot be compelled, or if research discloses a significant incidence of contractors defaulting on PRB obligations.** The Discussion Paper asks whether funding should be required to "substantiate" accrued PRB costs. We believe that a valid accrual does not need to be "substantiated" through funding for accounting purposes. This principle applies to pension costs as well as to PRBs. Funding requirements are, at bottom, a matter of procurement policy and not of cost accounting.

We do, however, agree that contractors should not be permitted to accrue costs without funding them in cases where the payment cannot be compelled. In such cases, no valid liability has been incurred unless the liability is funded. Additionally, if circumstances indicate that a contractor is likely to default on its PRB obligations, accrual without funding should not be allowed.

6. **Segment closings and plan terminations.** As stated in our earlier submission, it is equitable to both contracting parties to include in CAS a mechanism for adjusting prior years' costs for unrealized assumptions when a PRB plan terminates or a segment closes. Such adjustments may, as the Discussion Paper recognizes, result in large gains (due to benefit curtailments) or large losses (due to benefit enhancements). Whether or not such gains and losses are amortized over future periods or immediately recognized, we believe it is important to provide parallel treatment to both government and contractor, permitting both upward and downward cost adjustments, for purposes of equity.

In our earlier submission we counseled against reopening the **prices** of fixed price type contracts, or cost type contracts in years that are closed. Limiting the adjustment mechanism to **costs** only is consistent with sound procurement policy and will secure to the government and the contractor equally the benefit of their bargain. Moreover, the OFPP Act Amendments of 1988 do not provide the CAS Board with authority to adjust contract **prices**, other than the equitable adjustment mechanism for cost accounting practice changes or noncompliances that result in increased costs to the government. See Pub. L. 100-679, 26(h)(1), 41 U.S.C. 422(h)(1). For this reason, we believe that CAS 413-50(c)(12), as amended March 30, 1995, is subject to challenge as exceeding the Board's statutory authority.

If it is the Board's intent that adjustments of prior period gains and losses be carried forward to affect **future** pricing -- as opposed to prices of existing contracts -- this intent should be clarified.

7. **Avoid treating matters unrelated to cost accounting.** The CAS Board's charter extends to cost accounting matters only. The Discussion Paper continues to raise non-cost accounting matters such as public policy and reductions in the Federal budget. These are not appropriate subjects for Cost Accounting Standards.

* * *

Finally, we believe it is important for the CAS Board to **refrain from mandating actuarial assumptions.** No single set of assumptions will be appropriate for all contractors. Since, under our recommendation, it is likely that all health benefit PRBs would be governed by CAS 412, the guidelines for PRB actuarial assumptions should be consistent with those for pension costs in CAS 412. CAS 412 currently provides that actuarial assumptions shall represent the contractor's "best estimates of anticipated experience under the plan, taking into account past experience and reasonable expectations." CAS 412-40(b)(2).

**Conclusion**
In conclusion, the Section believes there may well be no need for a separate Standard governing accounting for PRBs. Retirement health benefits, under any sort of plan, are probably appropriately accounted for under CAS 412 and 413 by the same rules that apply to defined benefit pension plans. (However, modifications to these Standards to eliminate reference to contract price adjustments upon segment closing or plan termination must be made to conform to the Board's statutory authority.) Finally, life insurance for retirees is adequately covered by CAS 416, while all other PRB costs are probably immaterial.

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

Sincerely,

John T. Kuelbs
Chair, Section of Public Contract Law

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