OFFICE OF MANAGEMENT AND BUDGET

Office of Federal Procurement Policy

Cost Accounting Standard Relating to the Treatment of Costs of Post-Retirement Benefit Plans Other Than Pension Plans Sponsored by Government Contractors

ACTION: Notice.

SUMMARY: The Office of Federal Procurement Policy, Cost Accounting Standards Board (CASB), invites public comments concerning a Staff Discussion Paper on the treatment of costs of post-retirement benefit plans other than pension plans sponsored by Government contractors.

DATES: Comments must be in writing and must be received by December 19, 1996.

ADDRESSES: Comments should be addressed to Eric Shipley, Project Director, Cost Accounting Standards Board, Office of Federal Procurement Policy, 725 17th Street, NW, Room 9001, Washington, D.C. 20503. Attn: CASB Docket No. 96–02.

FOR FURTHER INFORMATION CONTACT: Eric Shipley, Project Director, (telephone: 410–786–6381) or Rein Abel, Director of Research, Cost Accounting Standards Board (telephone: 202–395–3254).

SUPPLEMENTARY INFORMATION

A. Regulatory Process

The Cost Accounting Standards Board's rules, regulations and Standards are codified at 48 CFR Chapter 99. Section 26(g)(1) of 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, 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, Cost Accounting Standards Board, is releasing a Staff Discussion Paper on the treatment of the costs of post-retirement benefit plans other than pension plans under Government contracts. Section 26(g)(1) of the Office of Procurement Policy Act, 41 U.S.C. 422(g)(1), requires that the Board, prior to the promulgation of any new or revised Cost Accounting Standard, 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. The purpose of the Staff Discussion Paper is to solicit public views with respect to the Board's consideration of the treatment of the costs of post-retirement benefit plans other than pension plans. This Staff Discussion Paper identifies 10 major topics, but respondents are welcome to identify and comment on any other issues they feel are important. This Staff Discussion Paper reflects research accomplished to date by the staff of the Cost Accounting Standards Board in the respective subject area, and is issued by the Board in accordance with the requirements of 41 U.S.C. 422(g)(1)(A).

The Cost Accounting Standards Board has received numerous public comments recommending that it establish a case concerning the measurement, allocation and period assignment of the costs of post-retirement benefit plans other than pension plans. These letters have come from Federal Government agencies, Government contractors, law firms, trade associations and other respondents. The Board has recognized the need to establish a case addressing post-retirement benefit issues. Accordingly, this Staff Discussion Paper was developed to identify the cost accounting issues related to post-retirement benefit plans.

Post-retirement benefit plans have existed for many years, sometimes as an adjunct to a company's pension plan, but they generally received little attention until 1979 when the Financial Accounting Standards Board (FASB) decided to examine the potential liabilities and costs of these plans. After seeking public comments through an exposure draft and a field test of a proposed standard, the FASB issued Statement No. 106 (SFAS 106) in December of 1990.

SFAS 106 exposed the substantial unfunded liabilities associated with post-retirement benefit plans. The costs and liabilities of post-retirement benefit plans often equal or exceed those of a company's pension plan. Over the last two decades, the growth rate of these costs and liabilities has exceeded general economic growth. During this same time period, some companies have looked for ways to either lower or control their post-retirement benefit liabilities by eliminating, curtailing, or otherwise limiting the benefit promise made to retirees. Companies have also been searching for tax-advantaged means of funding these liabilities. The efforts to limit, control, and fund post-retirement benefit liabilities continue to evolve, but few standard practices or solutions have yet emerged.

This Staff Discussion Paper identifies the following ten (10) major topics that the CASB staff believes should be considered in order for the Board to proceed with its rule-making process in this area. These topics as they relate to post-retirement benefit costs are:

A. Applicability of generally accepted accounting principles and existing Cost Accounting Standards.

B. Choice of accounting method or methods for measurement and period assignment.

C. Validity of the liability as a prerequisite for accrual accounting.

D. Choice of actuarial cost methods to measure and assign costs to periods for accrual accounting purposes.

E. Assignment of unfunded actuarial liabilities to accounting periods for accrual accounting purposes.

F. Actuarial considerations if accrual accounting is used.

G. The need, if any, to substantiate accruals by funding.

H. Cost determination for segments.

I. Accounting for plan terminations, liability settlements, and benefit curtailments.

J. Adjustments for segment closings.

The balance of the Staff Discussion Paper comprises short discussions of each topic highlighted above. The CASB staff is requesting comments and information regarding these 10 major topics. The staff also invites comments and information on any other post-retirement benefit issues which respondents believe should be considered. 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 submitting data, views or arguments with respect to this Staff Discussion Paper. All comments must be in writing and submitted to the

address indicated in the **ADDRESSES** section.

Richard C. Loeb,

Executive Secretary, Cost Accounting Standards Board.

Accounting for the Cost of Post-Retirement Benefit Plans Other Than Pension Plans Sponsored by Government Contractors

This staff discussion paper represents the results of research performed by the staff of the Cost Accounting Standards Board, and is issued by the Board in accordance with the requirements of 41 U.S.C. 422(g)(1)(A). The statements contained herein do not necessarily represent the position of the Cost Accounting Standards Board.

In response to the Cost Accounting Standards Board's continuing research, the Board has received a number of comments recommending that a case concerning the costs of post-retirement benefit plans other than pension plans under Government contracts be established. These letters have come from Federal Government agencies, Government contractors, law firms, trade associations and other respondents. In addition, a recent General Accounting Office report, *Cost Accounting Standards Board—Little Progress Made in Resolving Important Issues* (GAO/AIMD–94–88), also commented on the need for a Standard in this area. The Board has recognized the need to establish a case addressing post-retirement benefit issues, but because of the similarities between post-retirement benefits and more traditional pension plans, it was decided to defer commencement of this case until the pension case was completed.

The pension case was completed when the amendments to Cost Accounting Standards 9904.412 and 9904.413 were published as a final rule on March 30, 1995, 61 FR 16534. At its February 24, 1995 meeting, the CAS Board directed the staff to begin preliminary work on a Staff Discussion Paper addressing the accounting treatment of costs of post-retirement benefit plans.

Background

Post-retirement benefit plans have existed for many years, sometimes as an adjunct to a company's pension plan, but generally they received little attention until 1979 when the Financial Accounting Standards Board (FASB) decided to examine the potential liabilities and costs of these plans. After seeking public comments on a proposed financial accounting standard through an exposure draft issued on February 14, 1989 and after an examination of the practical implications of the proposed standard through a study performed by Coopers and Lybrand, the FASB issued Statement No. 106 (SFAS 106) in December of 1990.

Companies adopting SFAS 106 have disclosed substantial unfunded estimated liabilities associated with post-retirement benefit plans. The costs and liabilities of post-retirement benefit plans often not only equal or exceed those of a company's pension plan, but the growth rate of the liability for some post-retirement benefits exceeds that of general economic growth. Furthermore, the volatility of some of the rates and trends, coupled with the informality of many post-retirement benefit plans, mean there is a great degree of uncertainty in the estimates of the liabilities, especially the liability for retiree health care benefits.

During the 1980s and early 1990s, some companies looked for ways to either lower or control their post-retirement benefit liabilities by eliminating, curtailing, or otherwise limiting the formal and informal post-retirement benefit arrangements made with employees and retirees. Companies have also been searching for tax-advantaged means of funding these liabilities. The efforts to limit, control, and fund post-retirement benefit liabilities continue to evolve, but few standard practices or solutions have yet emerged.

When the CAS Board undertook to write Standards for pension costs, a relatively mature body of standards and practice had already evolved. Pension plans had been around since the early 20th century and had exploded in prominence during World War II when pension benefits were granted in lieu of salary increases, which had been frozen as a part of the war effort. The American Institute of Certified Public Accountants began examining post-retirement benefits with Accounting Research Bulletin Number 47 (ARB 47) in 1956. ARB 47 was superseded by Opinion Number 8 of the Accounting Principles Board (APB 8) in 1966. APB 8 addressed pension benefits and permitted a variety of accepted practices. Meanwhile, the economic and political environment of the 1960s and 1970s led to the enactment of tax incentives to encourage the establishment and funding of pension plans. In 1974, the Employee Retirement Income Security Act (ERISA) was passed to protect pension plan participants against abuses that had developed, to enhance controls on tax-deductible contributions, and to establish a benefit guarantee buttressed by minimum funding requirements.

In 1985, the FASB issued Statements 87 and 88 (SFAS 87 and SFAS 88) which replaced APB 8 with a more rigorous and standardized measurement of pension costs and liabilities intended to achieve fuller disclosure and better comparability of pension costs in financial statements. SFAS 87 and 88 were able to build upon the accrual accounting concepts of APB 8.

To complete the effort begun with ARB 47, the FASB then used concepts and principles from SFAS 87 and 88, where appropriate, to develop SFAS 106, ''*Employers' Accounting for Postretirement Benefits other than Pensions*''. SFAS 106 addresses non-pension post-retirement benefits and is intended to achieve fuller disclosure and better comparability of post-retirement benefit costs in financial statements. However, post-retirement benefits are often granted to an employee as an entitlement to a service, or reimbursement of the expenses of a service, so that the amount of benefit may not be determinable at retirement by either a formula or an account balance. Sometimes the promise is open-ended. Furthermore, the actual amount of benefits paid to or for an individual often depends upon that individual's morbidity after retirement rather than their service or salary during their years of employment. So, despite the similarities with pensions, the entitlement nature of many post-retirement benefits makes them very distinct from pension and other deferred compensation benefits.

Post-Retirement Benefits Defined

SFAS 106 defines a post-retirement benefit as any benefit, other than retirement income, that is deferred until after retirement and promised by an employer in exchange for current service. For SFAS 106 purposes, the post-retirement benefit promise arises from the written documents and established practices that comprise the ''substantive plan''. The most common forms of post-retirement benefits are retiree health care insurance [1] and retiree life insurance. Examples of other forms of post-retirement benefits are retiree discounts, legal services, adult day care, housing subsidies, and tuition assistance.

Like pensions, post-retirement benefits are paid to or on behalf of the employee after retirement. Post-retirement benefits also have attributes of employee insurance; e.g.,

[1] For purposes of this Staff Discussion Paper, the phrase ''retiree health care insurance'' can include hospitalization, medical, dental, vision, and prescription drug benefits, as well as Medicare Part B premiums.

hospitalization, medical, dental, prescription drug, and death benefits, and deferred compensation, adult day care allowances, housing subsidies, legal services, and tuition assistance.[2] It is important to bear in mind that post-retirement benefits share the attributes, issues, and problems of employee insurance and deferred compensation as well as pensions.

Actuaries practicing in the field of post-retirement benefits indicate that about 80% of the liabilities are for health care benefits; i.e, medical, hospitalization, dental, vision, and prescription benefits, and about 19% are for life insurance. All other forms of post-retirement benefits only account for about 1% or 2% of the liability.

Accounting for Post-Retirement Benefits Under SFAS 106 and Related Standards

SFAS 106 generally requires that the estimated liability for post-retirement benefits be recognized on an accrual basis during the years of service prior to the date an employee is first eligible for benefits. The unit credit actuarial cost method is used to assign the estimated liability[3] to these years of employment as an annual expense. The portion of the liability assigned to periods prior to the initial date of adoption of SFAS 106 is called the ''Transition Obligation''. The ''Transition Obligation'' may be fully recognized in the period in which SFAS 106 is first adopted or may be amortized over the employees' average remaining years of service, but not more than 20 years. Increases in the estimated liability due to plan amendments are always amortized over the employees' average remaining years of service. On the other hand, decreases in the estimated liability due to plan amendments are offset against any existing unrecognized prior service liability before being amortized. Experience gains and losses; i.e., the deviation of actual asset and liability values from amounts that were actuarially predicted as well as changes in the liability due to assumption changes, are recognized immediately. Only that portion of the gain or loss amount falling outside of a defined corridor is amortized over the employees' average remaining years of service.

[2] This Staff Discussion Paper addresses the accounting, that is, the measurement, assignment to periods, and allocation to cost objectives, of post-retirement benefit costs. This paper does not address the allowability of the costs for a particular category of post-retirement benefits.

[3] The SFAS 87 and 106 references to period attribution are analogous to the concept of period assignment as used in the Cost Accounting Standards.

In addition to the FASB's actions, the Governmental Accounting Standards Board (GASB), which establishes accounting principles for State and local governments, and the National Association of Insurance Commissioners (NAIC), which sets forth statutory accounting principles for insurance companies, have recently issued accounting standards for post-retirement benefit costs. Generally these standards follow the concepts of SFAS 106, but with some important exceptions. Statement 12 of the Government Accounting Standards Board (GASBS 12) requires that costs of advanced-funded post-retirement benefit plans be actuarially determined, but unlike SFAS 106, does not limit the choice of actuarial cost method. On the other hand, for purposes of statutory accounting by insurance companies, the measure of estimated liability only considers current retirees and those active employees who are currently vested or eligible for benefits. The annual service cost for statutory accounting only considers retirees, active employees eligible for benefits, and active employees who are or who may become vested during the year.

These are relatively recent promulgations. The recognition of post-retirement benefit plan costs does not have the framework, consistency of operational practice, nor history of funding that existed for pension plan costs when the CAS Board embarked on the pension project. Some believe that the budget deficits of the 1990s will preclude the creation of tax incentives to encourage the establishment and funding of post-retirement benefit plans. State and Federal legislators and policy makers are looking for ways to reduce or control the growth of retiree health care costs, including Medicare, through cost containment, managed care, and program re-design. The future of retiree health care costs, the largest and fastest growing category of post-retirement benefit cost, is uncertain.

The Need To Address Post-Retirement Benefit Accounting Issues

First, most Government contractors have now become subject to SFAS 106 and are disclosing for financial reporting purposes large estimated liabilities for post-retirement benefits, similar in magnitude to those of pension liabilities. Second, the procuring agencies and contractors are already struggling with the sometimes conflicting goals of consistency between periods, uniformity between contractors, and the substantiation of costs.

Finally, as some companies leave Government contracting as the defense industry downsizes, there is a question of the Government's responsibility for the large unfunded estimated liability for post-retirement benefits earned by workers with a long history of service under prior Government contracts. These three factors convinced the Board that issues pertaining to cost accounting, i.e., measurement, allocation and period assignment, for post-retirement benefits should be explored and addressed.

Therefore, through the issues raised in this Staff Discussion Paper, the Board is seeking information and comments regarding two central themes:

(1) On what basis should the Government determine; that is, measure, assign, and allocate, post-retirement benefit plan costs to be included in the prices of negotiated Federal contracts?

(2) To what degree, if any, should Government contract cost accounting of post-retirement benefit plan costs differ from generally accepted accounting principles?

An additional general issue will be whether any resolution of these issues should be addressed through an Interpretation, an amendment to existing Standard(s), or, through a new Cost Accounting Standard. The staff is aware that both procuring agency and contractor representatives have urged caution to avoid adding any unnecessary accounting requirements to an intrinsically complex and technical subject.

Preliminary Research

In developing this Staff Discussion Paper, the staff has solicited preliminary comments from certain interested and knowledgeable organizations and individuals from both the procuring agencies and contractor communities. The staff also sought comments from organizations and individuals from the accounting, actuarial, and legal professions. They were asked for assistance in identifying existing guidance and operational practices which should be explored. The staff would like to thank all the organizations and individuals who responded to the preliminary request for information. Their input and comments were very important in preparing this Staff Discussion Paper, which is the first step towards the possible promulgation of an Interpretation, an amendment to existing Standard(s), or a new Standard.

Issues concerning financial and Government contract cost accounting for post-retirement benefits are topics which have been treated in some detail

in accounting and actuarial literature.[4] The interplay between accountants and actuaries, which has produced issues that may affect cost accounting for post-retirement benefits, has also been discussed in accounting and actuarial literature.[5] To the extent that these articles have aided with the drafting of this paper, the staff would like to thank the authors.

Post-Retirement Benefit Issues

This Staff Discussion Paper identifies ten (10) major topics for consideration by the Board during its deliberations of any Interpretations, amendments to existing Standards, or a new Standard. Respondents are encouraged to identify other topics that they believe the Board should consider. The topics as identified in this Staff Discussion Paper are:

A. Applicability of generally accepted accounting principles and existing Cost Accounting Standards.

B. Choice of accounting method or methods for measurement and period assignment.

C. Validity of the liability as a prerequisite for accrual accounting.

D. Choice of actuarial cost methods to measure and assign costs to periods for accrual accounting purposes.

E. Assignment of unfunded actuarial liabilities to accounting periods for accrual accounting purposes.

F. Actuarial considerations if accrual accounting is used.

G. The need, if any, to substantiate accruals by funding.

H. Cost determination for segments.

I. Accounting for plan terminations, liability settlements, and benefit curtailments.

J. Adjustments for segment closings.

The balance of the Staff Discussion Paper comprises short discussions of each topic. Following the discussion of each topic, specific issues are identified. The staff is requesting comments and information regarding these issues. When responding to these issues, the staff would appreciate explanations of the reasoning that supports each comment. Where subparts of the issues are presented, the respondents are asked to address the main issue as well as each of the subparts. The staff invites comments and information on any other post-retirement benefit issues that respondents believe should be considered.

In writing this Staff Discussion Paper, the staff attempted to avoid any preconceptions or conclusions about the proper accounting treatment of post-retirement benefit plans for Government contract costing purposes. In particular, the staff has not presumed that either SFAS 106 or CAS 9904.412 should be the starting point.[6] In fact, one of the difficulties in addressing Government contract cost accounting for post-retirement benefits is that post-retirement benefits share attributes with pension, insurance, and deferred compensation plans. During its consideration, the Board may find that different types of post-retirement benefits may require different accounting treatments.

The CASB staff presumes that the readers of this Staff Discussion Paper are familiar with the provisions of CAS 9904.412, 9904.413, 9904.415, and 9904.416, as well as the Federal Acquisition Regulation (FAR) provisions regarding the award and administration of CAS-covered contracts. In addition, a familiarity with the FAR cost principles, in particular, FAR 31.205–6(o), is presumed.

In undertaking this project the Board is not constrained by nor confronted with conflicts in outside standards and practices as it was in the recent pension case. In this instance, except for the recent promulgations of the FASB, GASB, and the NAIC, there is a paucity of established common practice and efficient funding mechanisms, other than the use of pay-as-you-go financing, limited use of Voluntary Employee Benefit Association (VEBA) trusts, and some creative insurance products.

Topic A. Applicability of Generally Accepted Accounting Principles and Existing Cost Accounting Standards.

It is unclear whether post-retirement benefits are, or should be, covered by any of the existing Cost Accounting Standards. Before taking any action to interpret, amend, or expand the Standards for post-retirement benefit costs, the Board would have to determine that adequate guidance is not provided by generally accepted accounting principles for the measurement and assignment to periods and by existing Standards for allocation to intermediate and final cost objectives for Government contract cost accounting purposes. One possibility is for the Board to adopt or specify SFAS 106 as the accounting standard for post-retirement benefit costs. Or, the Board could adopt SFAS 106 but limit or modify any provisions or accounting treatments that may be inappropriate or inadequate for cost accounting.

Although the primary benefits provided through post-retirement benefit plans are retiree health care and life insurance benefits, the FASB developed SFAS 106 on post-retirement benefits using the concepts and techniques of SFAS 87 and 88 on pensions. Thus, since one of the concepts adopted by the Board is to follow generally accepted accounting principles wherever practicable, CAS 9904.412 and 9904.413 would seem to be the analogous Cost Accounting Standards to serve as the starting point for post-retirement benefit plans. However, the only specific reference to retiree insurance is found at CAS 9904.416–50(a)(1)(v). At first, many in the procurement community expressed a belief that post-retirement benefits were another form of pension benefits and were therefore subject to CAS 9904.412 and 9904.413. In response to an inquiry from the Financial Executives Institute, the Administrator of the Office of Federal Procurement Policy (OFPP) and Chairman of the CASB, stated: ''[E]xisting CAS pension or insurance coverage does not appear to offer a basis for treating PRB costs. In fact, the post-retirement benefit nomenclature barely existed at the time of the earlier Board.''[7] However, this statement represents guidance from the Administrator of OFPP and is not an official interpretation by the Board.

The confusion increased as some individuals in the accounting profession expressed a belief that the CAS Board intentionally included post-retirement health care benefits in the pre-March 30, 1995 version of CAS 9904.412–50(a)(9) which stated: ''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 will be considered as a single plan for the purpose of this Standard.'' Others believe this clause was added to address the total pension benefit provided through the combination of a defined-benefit with a

[4] For example, the article ''*Post-Retirement Benefits: Accounting for and Recovering the Cost of Health Care for Retirees*'' (Public Contract Law Journal, Vol. 24, No. 3, Spring 1995), written by Brian Mizoguchi, gives an excellent overview of the subject and associated cost accounting issues.

[5] For a discussion of the tension between the accounting and the actuarial professions concerning responsibility for the measurement of Post-retirement benefit liabilities, see ''*Impact of the Actuarial Profession on Financial Reporting*'' (Accounting Horizons, Vol. 9, No. 3, September 1995) by Timothy J. Fogarty and Julia Grant.

[6] This paper addresses many issues similar to those considered in the March 30, 1995 amendments to CAS 9904.412 and 9904.413. The fact that issues are raised in this Staff Discussion Paper on post-retirement benefit costs does not imply changes will be made to the pension Standards.

[7] Letter dated November 25, 1991 from Dr. Allan V. Burman to Messrs. Fuqua and Hogg of the Aerospace Industries Association and the National Security Industrial Association, respectively.

defined-contribution plan, which were commonly referred to as ''floor-offset plans'', or the combination of an ''excess benefit'' nonqualified plan with a qualified plan. Such combinations were specifically being addressed by ERISA. There is no evidence that post-retirement health care benefits were a consideration in the mid-1970s when CAS 9904.412 and 9904.413 were originally promulgated. However, this language does raise the question of whether separate accounts within a qualified pension trust established for Internal Revenue Code (IRC) § 401(h) health care benefits should be considered as providing an ancillary benefit that is an integral part of a pension plan that covers the same population.

The first set of issues concerns how the case should evolve. Should Government contract cost accounting for post-retirement benefit plans be addressed through SFAS 106, a CASB Interpretation, an amendment(s) to an existing Standard(s), or by a new separate Standard? At a minimum, any consideration of amendments or additions to the Standards would seem to require a review of the CAS 9904.416 provisions regarding funded reserves for retirees.

CAS 9904.416 generally does not distinguish between various types of insurance. However, there have been suggestions that employee benefit coverages; that is, life, health care, and disability insurance, should be separated from property, casualty, liability, and workers compensation insurance.[8] Such separation is reflected in the recent revisions to the CASB Disclosure Statement, DS–1. It may be appropriate for the Board to consider whether 9904.416 is too broad because it attempts to combine two similar, but unrelated, types of insurance. The life and health insurance industry, through which most employee benefits are provided, is governed by a separate set of state laws and is represented by a separate industry association and actuarial society from those of the property and casualty insurance industry. But, because dividing 9904.416 into two Standards could expand the scope of the instant case on post-retirement benefits, it may be more feasible to address only the provisions of CAS 9904.416 relating to post-retirement benefits now and to identify the full review of CAS 9904.416 as a potential subject of a future CASB case.

Issue 1: Does GAAP provide adequate guidance for the measurement and period assignment of post-retirement benefits? Explain why or why not and discuss the pros and cons.[9]

a. Does SFAS 106 provide sufficient guidance on the measurement and period assignment of post-retirement benefit costs for Federal contract costing purposes?

b. Identify any provisions of SFAS 106 that may be adequate or inadequate for the measurement and assignment to periods of Government contract costs. Discuss in detail the modifications or limitations that may be necessary.

c. Are there other financial accounting standards; e.g., GASBS 12 or statutory accounting principles, that would provide more appropriate guidance on the measurement and period assignment of post-retirement benefit costs for Federal contract costing purposes?

d. If GAAP is used for measurement and period assignment of post-retirement benefits costs, do existing Cost Accounting Standards provide sufficient guidance on the allocation of such costs to Federal contracts?

Issue 2: Should the Board issue an Interpretation specifying which elements of post-retirement benefit costs are addressed by existing CAS 9904.412 and 9904.413 relating to pension plans, CAS 9904.415 relating to deferred compensation plans, and CAS 9904.416 relating to insurance?

Issue 3: Should the Board establish specific accounting provisions for the various elements of post-retirement benefit costs by appropriately amending some or all of the four Standards that address employee benefits, i.e., CAS 9904.412, 9904.413, 9904.415, and 9904.416?

Issue 4: Should the Board address post-retirement benefits through a new, separate Standard?

a. To what extent should a new Standard draw on language already found in CAS 9904.412, 9904.413, 9904.415, and 9904.416 to achieve consistency with the concepts, definitions, and accounting provisions of these four Standards?

b. To what extent do the issues unique to post-retirement benefits require a different accounting treatment?

Issue 5: As part of this case, should the Board amend CAS 9904.416 to reflect the differences between life and health insurance and property and casualty insurance?

Topic B. Choice of Accounting Method or Methods for Measurement and Period Assignment

The CASB pension Standards and insurance Standard permit costs to be assigned to cost accounting periods by use of any one of three methods; cash accounting, terminal funding, or accrual accounting. The less technically challenging CAS 9904.415 bases the cost of annual deferred compensation awards on a single method; i.e., the present value of the contractor's obligation for the award earned by that year's service. Because of its focus on comparability between financial statements, SFAS 106 mandates the use of accrual accounting based on a specific actuarial cost method.

A primary consideration will be whether post-retirement benefits should be accounted for using a single accounting method or if, and when, alternative accounting methods would be appropriate. Any decision in this area must find a balance between three different goals; consistency in cost assignment between cost accounting periods, greater uniformity among contractors in measuring their program costs, and matching of cost to appropriate benefitting activities.

(i) Single versus multiple accounting methods

As with pensions, post-retirement benefit costs could extend over a significant number of years, contracts, and programs. From this perspective, predictability that is based on consistency of cost assignment between cost accounting periods is desirable for forward-pricing and program budgeting purposes. With possible reductions in government contracting due to Federal budget restraint and the reduction in the number of contractors due to mergers and acquisitions, the importance of a level playing field for competitive pricing through more uniformity in cost data determination among contractors has become even more pronounced. Furthermore, because so many contracts and programs are affected over the extended period of time during which post-retirement benefits are earned, the proper matching of costs to their benefitting activities is necessary for inter-program consistency.

Several contractor representatives have noted that cash accounting would satisfy the Government's primary desire for funding. With cash accounting there is little question about the verifiability of the cost, but cost recognition is deferred until the latest possible moment. In most instances, the principle of matching cost with the

[8] Worker's compensation is a form of liability insurance that covers a contractor's legal responsibility for injury for which it is culpable.

[9] Throughout this Staff Discussion Paper, the staff requests that respondents explain the reasoning for their conclusions.

benefitting activities is clearly violated. Because a single cash payment in the current period represents both liability liquidation and cost recognition, there are no expenses for obtaining actuarial valuations and most other administrative expenses are minimal. However, the cost incurrence will be completely disconnected from the benefitting activity because of this delay. Cash accounting is most appropriate for obligations whose future payment is questionable or which are difficult to estimate or quantify within reasonable limits.

With cash accounting there is a concern with the possible recognition of the Government's share of any future estimated liability not covered by current contract pricing. Many believe that *Remington Arms* [10] suggests that the Government has a responsibility for any unfunded post-retirement benefit liability in certain special contractual relationships, such as a Government-owned contractor operated (GOCO) facility. Some argue that in such cases the Government may have encouraged the use of cash accounting in the past because it benefitted from the resulting lower contract costs. If cash accounting is permitted or mandated for Government contract costing purposes, this issue may have to be addressed as part of any guidance on the final settlement of contract costs if the contracting relationship ends. This issue is discussed in more detail under Topic J.

Terminal funding is an improvement over cash accounting in that cost recognition occurs somewhat closer to the incurrence of the cost. But, under terminal funding the pattern of cost assignment is very dependent upon the plan demographics and can produce very inconsistent results from period to period, even for plans with large populations. Moreover, terminal funding can be viewed as simply a subset of cash accounting in which the cash outlays occur in lump sums at retirement, rather than as periodic payments over the participants' retirement years. Terminal funding generally shares the advantages and disadvantages of cash accounting. However, the market for terminal funding in the area of retiree health care benefits is virtually non-existent. To improve consistency between periods, many contractor and Government agency representatives believe that terminal funding, if used to account for post-retirement benefit costs, should be subject to an amortization requirement similar to the one at CAS 9904.416–50(a)(1)(v)(C).

Accrual accounting provides the best matching of costs to benefitting contracts and programs. Accrual accounting, properly implemented, also enhances consistency between contract periods, and thereby enhances predictability for forward-pricing purposes. However, accrual accounting is only appropriate when the obligation is valid; that is, reasonably expected to occur and can be reasonably estimated.[11] Accrual accounting for post-retirement benefits would be based on expectations of long-delayed events and on actuarial estimates of obligations that may not be fully liquidated for years, if at all. And, there are significant administrative expenses associated with these actuarial estimates and the necessary record keeping.

On the other hand, as the retiree proportion of post-retirement benefit plans grows with the aging of the workforce and contractor downsizing, pay-as-you-go (cash accounting) costs will sooner or later exceed the accruals. Thus, from the perspective of a program manager, the costs of post-retirement benefit plans might be more manageable in the long run if accrual accounting is adopted now instead of facing escalating pay-as-you-go costs in later years when many expect procurement budget pressures to further increase.

Very different results are produced by accrual accounting, cash accounting, and terminal funding, making it difficult to compare cost or price proposals from competing contractors if several methods are permitted for Government contract costing purposes. Besides the differences in cost for the current period, one contractor may realize lower costs from having adopted fully-funded accrual accounting earlier while another contractor may achieve lower costs by avoiding current accruals in favor of deferred cash payments. In such instances, there would be little uniformity in the cost recognition patterns over time.

Contractor representatives who have shared information on how their individual companies treat post-retirement benefits, indicate that current contractor practices range from fully-funded accrual recognition to traditional cash accounting. They note that terminal funding is sometimes used for life insurance, but seldom or never for retiree health care benefits. A contractor's choice of accounting method is currently determined by many factors; such as, size of its Government business base, type(s) of benefit, industry practice, availability of tax-advantaged funding, and the type of covered employee population; e.g., union or non-union, production or management.

Issue 6: Should cash accounting be permitted for post-retirement benefit costs of Government contractors?

a. If so, should cash accounting be mandatory if the post-retirement benefit plan is unfunded?

b. Should cash accounting be mandatory if the post-retirement benefit liability is not reasonably predictable?

Issue 7: Should terminal funding be permitted for post-retirement benefit costs of Government contractors?

a. If so, should cost recognition be based on the terminal funding payment made during the period?

b. Are there circumstances when the terminal funding payment should be subject to amortization for cost recognition purposes?

c. Should the terminal funding payment always be subject to amortization for cost recognition purposes?

Issue 8: Should accrual accounting be permitted for post-retirement benefit costs of Government contractors?

a. Other than concern with the validity of the liability and the possible need for funding which are discussed as subsequent topics, are there certain criteria that must be met as a prerequisite for using accrual accounting?

b. Should accrual accounting be mandatory if certain criteria are met? If so, describe the criteria.

Issue 9: For uniformity between contractors, should measurement and assignment of post-retirement benefit costs to periods be restricted to a single accounting method? If so, identify that method.

Issue 10: If different accounting methods may be used by different contractors, explain how and when each method should be used.

(ii) Different accounting methods for different benefit types

Although SFAS 106 treats all post-retirement benefits alike, the CAS Board may wish to consider whether different accounting methods may be appropriate for different types of benefits. Natural divisions seem to be health care insurance, life insurance, and ''other'' benefits (legal services, housing subsidies, adult day care). Similarly, the Board may wish to consider whether a contractor should be permitted to elect to use different accounting methods for different post-retirement benefit plans or for different benefits within the same plan.

[10] Army Contract Adjustment Board (ACAB) Decision No. 1238 (1991).

[11] See Topic C for a discussion of the validity of post-retirement benefit liabilities.

Contractor representatives and their actuaries have suggested that, because of the added administrative and actuarial expenses, the accounting treatment should not be separated by type of benefit. In fact, they believe that benefits other than health care insurance and life insurance are not sufficiently material to justify special treatment since they only comprise about 1% or 2% of total post-retirement benefit costs.

The Board will have to determine what constitutes a post-retirement benefit plan. Under SFAS 106, a ''substantive plan'' may comprise a formal plan document and trust agreement, an undocumented, but well established practice, or a mere reference of intent in an employee handbook. This definition of substantive plan is appropriate for the SFAS 106 purpose of disclosing to investors, shareholders, and lenders, an entity's potential liabilities. CAS 9904.412 and 9904.416 require the purpose of a trust fund or reserve for retiree benefits be set forth in writing as a precondition for accrual accounting. If the SFAS 106 definition of a post-retirement benefit plan is determined to be inadequate for Government contract costing purposes, it may be desirable to require that the obligation be evidenced in writing as a precondition for the use of accrual accounting.

Different contractors may provide similar benefit plans, but package the benefits differently. Consider the following illustration. Contractor X may have four formal documents covering all its employees; one each for retiree medical benefits, retiree dental coverage, retiree life insurance, and retiree discounts. Another contractor, Contractor Y, may provide combined retiree medical, dental, life, and discount benefits through two similar plans, each of which covers different employee populations; i.e, union and non-union employees. If different accounting methods are permitted for different benefits, could Contractor Y elect different accounting for its retiree health care and life benefits provided by the same ''plan'', or would such an election only be available to Contractor X?

Even more problematic is when the same health care plan provides the same benefits to active employees and retirees. Some contractor representatives have expressed an interest in treating the two participant categories; i.e, active and retired, as separate plans. If permitted they would like to use cash accounting (based on premium payments) for current retired employees while using accrual accounting for the post-retirement benefits of the active population.

Issue 11: Is the SFAS 106 description of a post-retirement benefit plan adequate for Government contract costing purposes?

a. If not, please describe any modifications or restrictions to the SFAS 106 description that you believe are necessary.

b. Is there an alternative definition that the Board should consider?

Issue 12: Should different accounting methods for different types of post-retirement benefits be permitted when the benefits are provided by the same contractor?

a. If multiple accounting methods are considered appropriate, should the permitted accounting method or methods be dependent on the type of post-retirement benefit provided by separate plans?

b. If multiple accounting methods are considered appropriate, should different accounting methods be permitted for different benefits provided through the same plan?

c. If multiple accounting methods are considered appropriate, should different accounting methods be permitted for different groups within the same plan population; e.g., union versus non-union, active employees versus retirees?

Issue 13: Whether or not multiple accounting methods are considered appropriate, should an administratively less burdensome form of cost accounting be permitted for certain *de minimis* benefits; e.g., adult day care, legal assistance?

a. Should cash accounting be permitted for *de minimis* benefits?

b. Should *de minimis* benefits, whose payment does not involve life contingencies, be specifically subject to CAS 9904.415, deferred compensation rules?

c. How should *de minimis* benefits be defined? Can that definition be readily related to the CAS materiality criteria in 9903.305?

Topic C. Validity of the Liability as a Prerequisite for Accrual Accounting

In considering whether accrual accounting is appropriate for the measurement and period assignment of post-retirement benefit costs to contracts, the CAS Board will have to assess the validity of the estimated liability. A valid liability derives from an event which is expected to occur and the cost effect of which can be reasonably estimated. For purposes of this Staff Discussion Paper, a valid liability is distinguished from a contingent liability for events whose actual occurrence cannot be reasonably predicted or the cost effect cannot be reasonably estimated.

As with pensions, use of any accrual accounting method for post-retirement benefit plans could create an extended period of delay between cost recognition and benefit payment. This delay raises additional concerns about the validity of the liability. The conservative nature of GAAP leads it towards accrual accounting for not only contractual obligations, but also for informal, and possibly unenforceable, benefit promises. The FASB is concerned that to not disclose these liabilities would imply that no liability exists. Therefore, the question is whether the recognition criteria of SFAS 106 are also applicable for accrual of the cost and the recognition of cost in the Government contracting environment?

Furthermore, some companies have been actively amending, replacing, and eliminating retiree health care plans to contain or eliminate post-retirement benefits costs. The possibility of a retiree health care benefit being greatly reduced or eliminated is much greater than that for pension benefits which fall under the protections of ERISA. Also, because there are limited tax-deductions available for funding post-retirement health care benefits, some companies have been shifting costs to participants through higher deductibles, co-payments, and caps on employer-paid costs. Therefore, it seems that the validity of a liability for a benefit that can be significantly avoided by the unilateral action of a contractor could be questioned. The presumption that a post-retirement benefit plan will continue has less certainty than a comparable pension plan subject to ERISA.

In addition to the documentation requirements similar to those found in CAS 9904.412 and 9904.416, there may be other criteria that should be met before post-retirement benefit costs can be accrued for Government contract cost accounting purposes. After retirement, defined-benefit pension costs are dependent only on investment results, mortality, and possibly a limited adjustment for general inflation. Retiree health care costs are dependent not only on investment results, mortality, and general inflation, but utilization, intensity, and medical inflation rates. Unforeseeable changes, which are not anticipated in the actuarial assumptions, such as future medical advances, changes in delivery systems, new diseases, and increasing health care provider competition will also affect future retiree health care costs. Health care actuarial assumptions; e.g., utilization, intensity, and medical

inflation rates, possess a much greater degree of uncertainty than the economic and mortality assumptions used for pension plans. An important issue concerns the degree of uncertainty that makes an event, or the quantification of the effects of an event, a contingency rather than a reasonable expectation.

Retiree health care plans are often integrated with Medicare, so that after age 65, the benefit structure is that of a Medigap policy that covers costs not paid by Medicare. Coupled with the uncertainty of the assumptions, there are the widely disparate potentialities, over the long-term, for either a complete third-party assumption of company health care liabilities (e.g., a substantial increase in Medicare benefits), which would eliminate or reduce contractors' retiree health care costs, or, conversely, a revised Medicare program that would increase contractors' retiree health care costs. The CAS Board may have special concerns about the appropriateness of use of accrual accounting for retiree health care costs as opposed to retiree life and other benefits. Instead of valuing projected benefit levels, perhaps a liability measurement based on current, that is unprojected, benefit levels would be a more reliable, and therefore appropriate basis, for determining the valid liability to be recognized in the current cost accounting period. The effects of inflation on all benefits and the effect on health care benefits due to changes in utilization and intensity would have to be recognized in future periods as the cost effects emerge.

Issue 14: Can post-retirement benefit liabilities be reasonably estimated; i.e., is there a valid liability, given the degree of uncertainty in projecting post-retirement benefit levels?

Issue 15: Because of the uncertainties in projecting retiree health care benefits and trends, in particular long-term medical cost trends, should accrual accounting for post-retirement health care benefits only recognize current benefit levels?

Issue 16: Because of the uncertainties about future reductions or other changes to the benefit promise, should accrual accounting for all post-retirement benefits only recognize current benefit levels?

Issue 17: Should the validity of the liability be dependent on the formality of the post-retirement benefit plan?

Issue 18: Are there other criteria that should be used to assess the validity of the post-retirement benefit liability?

Topic D. Choice of Actuarial Cost Methods To Measure and Assign Costs to Periods for Accrual Accounting Purposes

The current CAS Board, like its predecessor, believes that generally accepted accounting principles should be used as a basis for determining contract costs for a valid liability whenever practicable. However, the Board has long recognized that GAAP concepts and methods must be scrutinized, and possibly modified if otherwise acceptable, to address the special needs of Government contracting because of its emphasis on predictability of cost allocations between cost accounting periods used for Government contracting purposes rather than the stressing of current period comparability between companies that seems to predominate financial accounting. In this case, one of the most crucial determinations is how the estimated liability for post-retirement benefits is assigned to cost accounting periods. Period assignment is the foundation on which subsequent allocation to intermediate and final cost objectives is based.

Many contractor and Government representatives have suggested that the Board adopt GAAP, as represented by SFAS 106, only adding safeguards truly needed to protect the Government's interests. Some believe pure SFAS 106 accrual accounting, augmented with explicit reversionary rights for the Government in case of an asset reversion, may be sufficient. However, this use of SFAS 106 presumes that post-retirement benefits are analogous to pensions. This presumption appears to be reinforced by the prefatory section of SFAS 106 entitled, ''*Similarity to Pension Accounting*'', in which the FASB specifically acknowledges that SFAS 106 is based on SFAS 87 and 88 pension accounting principles.

CAS 9904.412 permits the use of any immediate-gain actuarial cost method to apportion, that is, assign, the pension liability over the employees' total years of service. The accrual pattern for a funded pension plan, disregarding any funding limitation, can either be a level amount in dollars or a level percentage of payroll; i.e., as determined under the Entry Age Normal (EAN) actuarial cost method, or can be generally increasing; i.e., as determined under the Accrued Benefit Cost Method (ABCM) or the Projected Unit Credit (PUC) actuarial cost method. CAS 9904.416 requires that the projected average loss; i.e., the annual accrual, for advanced-funded retiree insurance programs be actuarially determined and apportioned over the working lives of the active population.[12] The CASB staff questions whether contract cost determinations made under the projected average loss methodology constitute accrual accounting. The projected average loss method appears to be an actuarial smoothing technique applied to cash accounting, especially considering that refunds and credits are fully recognized when received.

For SFAS 87 pension accounting, the FASB mandated use of the unit credit family of methods (ABCM and PUC) because the period assignment is tied to the employment service by which benefits are incrementally earned. Often, entitlement to post-retirement benefits is not earned ratably, but occurs instantaneously when the employee meets an age and service eligibility requirement. In such cases, the even apportionment requirement of CAS 9904.416 might be more appropriate.

Issue 19: If accrual accounting is used independent of SFAS 106, what actuarial method or methods should be used to assign the estimated liability to cost accounting periods?

a. Should period assignment be limited to a single actuarial cost method?

b. If the projected unit credit actuarial cost method is used, should period assignment follow the benefit formula attribution method or use ''project and prorate'' method?[13]

c. If the plan population is predominantly composed of retirees should costs be attributed to the future life expectancy of the retiree population?

Issue 20: Is the projected average loss methodology of CAS 9904.416 an appropriate actuarial cost method for accrual accounting?

Issue 21: Are there other methods of period assignment that you believe should be considered?

E. Assignment of Unfunded Actuarial Liabilities to Accounting Periods for Accrual Accounting Purposes

If accrual accounting is used, post-retirement benefit costs will be dependent on actuarial techniques and assumptions. Actuarial cost methods measure and assign portions of the total liability to past, current, and future

[12] If the population predominantly comprises retirees, then the liability is apportioned over the average life expectancy of the population.

[13] Under the ''project and prorate'' method, the projected liability at full eligibility age is apportioned over the employee's years of service without regard to how benefits are actually incrementally earned based on the benefit formula. Use of this method is most common in instances where the benefit is not ratably earned over years of employment.

periods. When a post-retirement benefit plan is first established or accrual accounting first adopted, the portion of the total liability that the actuarial cost method assigns to prior years is identified as the initial actuarial liability, which is sometimes known as the past service liability. The portion of this liability that is not currently secured by assets is the initial unfunded liability. Portions of the total liability assigned to prior periods by the actuarial cost method can also arise from subsequent changes in the benefit design, actuarial cost method, and actuarial assumptions.[14] Actuarial practice typically reassigns these previously unrecognized past service liabilities to current and future periods through an amortization process.

(i) Initial Unfunded Liability

SFAS 106, which considers the liability valid for financial accounting purposes, permits the initial unfunded liability, which is referred to as the ''Transition Obligation'', to be fully recognized in the period in which SFAS 106 is adopted, to be amortized over the average remaining years of service of the employees at the time of adoption. Many have noted that amortization would minimize the disruption of the forward-pricing and program budgeting processes by spreading the recognition of this large, and long-neglected, past service liability over many future years. Much of the large initial unfunded liability can be attributed to prior periods when there may have been very different levels of Government work performed by a contractor. In such instances, amortization over the remaining years of service would recognize the initial unfunded liability during future periods of lower, or possibly further changing, Government participation.

Few contractors used accrual accounting to price their Federal contracts prior to the issuance of SFAS 106. Since most contractors ignored the liability for post-retirement benefits prior to the promulgation of SFAS 106, some believe that the Government has no responsibility for these liabilities that have appeared only when the prior practice of cash accounting was been abandoned. A practical issue will be whether to, and how to, identify the Government's share, if any, of the initial unfunded liability.

CAS 9904.412 provides for the recognition of the initial unfunded liability, that is, the unfunded actuarial liability attributable to prior periods when a pension plan is first established, by providing that such initial unfunded liability will be reassigned to future periods through an amortization process. An alternative treatment of this initial unfunded liability would be to set it aside from other portions of the unfunded actuarial liability being recognized for Government contract costing purposes and treat it as a separate or ''exceptional'' item. If this treatment were adopted, the period cost would comprise the normal cost or projected average loss, plus recognition of gains and losses, and prospective changes to the plan, actuarial assumptions, or actuarial cost method. This approach would permit the Government and a contractor to establish a short term relationship without having to adjust contract costs for liabilities and assets accumulated, but not recognized, during prior periods.[15]

Issue 22: To what extent, if any, should the initial unfunded liability of post-retirement benefit plans be recognized for Government contract costing purposes?

Issue 23: If the initial unfunded liability is recognized, should it be fully recognized in the cost accounting period when accrual accounting is adopted or should it be amortized? If amortized, what should the amortization period be?

Issue 24: If the initial unfunded liability is recognized, should there be some consideration of historical Government participation levels in the allocation of the initial unfunded liability to current and future contracts?

a. If yes, how should such a recognition be measured? Would permitting accrual accounting as an optional election rather than a mandated method affect your answer?

b. Alternatively, to better match the amortization installments with the current level of Government contracting, should the SFAS 106 amortization method of level principal payment and declining interest equivalents be used? What about using a shortened amortization period; e.g., 10 years.

Issue 25: If the initial unfunded liability is not recognized, should accrual recognition be further limited to the normal cost plus recognition of experience gains and losses and assumption changes?

Issue 26: Are there alternative accounting treatments that the Board should consider for the initial unfunded liability?

(ii) Changes in Unfunded Actuarial Liability Due to Experience Gains and Losses

Actuarial assumptions are estimates of future conditions affecting costs. For post-retirement benefits, the assumptions include future trends affecting health care costs; e.g., medical cost inflation, utilization, and intensity, in addition to the events considered for pension costs. And, like pensions, actual experience will differ from actuarial expectations. GAAP, as expressed in SFAS 106, favors current period recognition of the experience gains and losses as they occur. The Cost Accounting Standards are divided on this subject. CAS 9904.413, which is concerned with consistency between periods, requires that experience gains and losses be amortized over a 15 year period. CAS 9904.416–50(a)(1)(vi) would seem to require that experience gains and losses; i.e., the difference between estimated and actual refunds, dividends, and assessments, be recognized in the period that the difference is first known.

In SFAS 106, the FASB limits the immediate recognition of gains and losses to a corridor, which is related to the benefit liability and the market value of any assets. Any gain or loss falling outside of the corridor is amortized over the employees' average remaining years of service. CAS 9904.413 requires that experience gains and losses be amortized over 15 years to dampen the volatility of annual market movements. For Government contract cost accounting of post-retirement benefit plans, it may be desirable to use a shorter amortization period so that the gain and loss recognition will be closer to the period when the gain or loss occurred. Concerns with predictability and forward-pricing would seem to argue for amortization. The Board may have to seek a proper balance between early recognition and increased volatility.

Issue 27: Should experience gains and losses be recognized in the period of occurrence?

a. If yes, should the current period recognition be limited to a corridor? How should that corridor be defined?

b. If generally no, is there some *de minimis* level of gain or loss that should be recognized in the current period?

c. Are there certain recurrent gain or loss events that should be recognized immediately?

[14] Changes in actuarial assumptions, actuarial cost method, or underlying benefit promise may also constitute a change in accounting practice, which is the subject of a separate CASB case currently under consideration.

[15] This discussion is focused on the recognition of prior period costs at the time a contractor first becomes subject to a Standard on post-retirement benefit costs. Topic J discusses the recognition of prior period costs at the time a contracting relationship ends.

Issue 28: Should experience gains and losses be amortized?

a. Should a longer amortization period; e.g., 15 or 20 years, be used to enhance consistency between periods by dampening volatility?

b. Should a shorter amortization period; e.g. 5 or 10 years, be used to keep recognition closer to the period in which the gain or loss occurred?

c. Should the amortization period reflect the average remaining years of service for the plan's active population? What if retirees predominantly comprise the plan population?

Issue 29: Are there other methods of recognizing experience gains and losses that should be considered?

(iii) Other Changes in Unfunded Actuarial Liability

In addition to experience gains and losses, the treatment of all other changes in the liability must be addressed. The Board will have to specifically address the cost accounting for changes in the actuarial assumptions, the actuarial cost method, and the benefits or plan design.

Because SFAS 106 promotes recognition of current conditions, the effects of actuarial assumption changes are included with the experience gain or loss. CAS 9904.412, which was modeled after APB 8 and ERISA, treats changes in liability due to changes in actuarial assumptions separately from experience gains and losses. Under SFAS 106, the choice of the discount rate is restricted in that it must fit certain criteria set forth in SFAS 106 as well as guidance from the Securities and Exchange Commission. The discount rate, and certain other actuarial assumptions, must reflect current conditions which are assumed to be beyond a contractor's control. Therefore, it is consistent to report the effects of changes to such assumptions as part of the experience gain and loss. Conversely, CAS 9904.412 requires that all actuarial assumptions reflect a contractor's long-term expectations. Because the timing and degree of assumption changes is generally under the control of the contractor, CAS 9904.412 does not consider the effects of such changes to be experience gains and losses from external forces [16].

SFAS 106 does not address changes in actuarial cost method because the cost method is mandated. If choice of actuarial cost method is permitted for cost accounting, the recognition of the effect of an actuarial cost method change on the liability estimate will have to be addressed. Also, for consistency, any change in actuarial cost method, if permitted, probably should be treated as an accounting practice change as it has been with pensions.

Included in the CAS 9904.412 definition of actuarial cost method is the asset valuation method. Both SFAS 106 and CAS 9904.413 permit the use of actuarially determined asset values whereby single period investment experience volatility is smoothed through an asset valuation method. Such asset valuation methods typically amortize asset gains and losses over a five (5) year period. To maintain reasonable values, CAS 9904.413 requires that the actuarial value of assets fall within a specified corridor related to market value. If asset smoothing techniques are not permitted, the CAS Board may wish to consider whether amortization of experience gains and losses over the somewhat extended 15 year period or average remaining years of service provides adequately for current asset values, or whether amortization of asset gains and losses over a shorter time frame; e.g., five years, should be permitted, or even mandated.

As with experience gains and losses, SFAS 106 requires that increases in the estimated liability (losses) due to plan amendments are always amortized. On the other hand, decreases in the estimated liability (gains) due to plan amendments are offset against any existing unrecognized prior service liability before being amortized. Under CAS 9904.412, the effects of plan changes are amortized regardless of whether the liability increases or decreases. The Board will have to consider the proper cost accounting for changes in liability due to plan amendments.

Finally, for situations where the CAS Board determines that amortization of the effect of a change is appropriate, the Board will have to consider the appropriate amortization period. CAS 9904.412 permits a contractor to select, based on predetermined criteria, the amortization period. The amortization period can range from 10 to 30 years and the criteria should consider materiality and the nature of the change. SFAS 106 specifies that the amortization period be equal to the employees' average remaining years of service. Factors the CAS Board may wish to consider are consistency between periods, uniformity between contractors, and the delay in the recognition of changes in the estimated liability.

Issue 30: Should the effect of a change in actuarial assumptions be treated separately from experience gains and losses?

Issue 31: Should the effect of a change in actuarial cost method, including the asset valuation method, be treated separately from experience gains and losses?

Issue 32: Should the use of actuarially determined asset values be permitted for the recognition of some asset gains and losses that would otherwise be treated as an experience gain or loss?

a. If yes, should the actuarially determined assets value be related to the market value of the assets? If so, how?

b. What limits and criteria should apply to the actuarial determination of the asset values; e.g., time period over which these asset gains and losses are spread?

c. Should the asset valuation method be considered to be part of the actuarial cost method?

Issue 33: Should the effect of a change in benefits or plan design be treated separately from experience gains and losses?

Issue 34: Should the amortization period for recognizing changes in the actuarial liability be specified?

a. If yes, what should the specified amortization period be? Should the amortization period differ depending on the cause of the change in actuarial liability; e.g., emerging experience gain or loss, change in benefit or plan design, change in actuarial assumptions, change in actuarial cost method?

b. Alternatively, should a contractor be permitted to select the amortization period?

c. If a contractor may select the amortization period, what criteria, if any, should be imposed on that selection?

d. If a contractor may select the amortization period, should the amortization period be fixed once selected? If the period is not fixed, how does one address changes in the amortization period?

Topic F. Actuarial Assumption Considerations if Accrual Accounting is Used

The SFAS 106 criteria for selecting actuarial assumptions, some of which are based on current market conditions, can produce volatility which is counterproductive to consistency between periods, and therefore to predictability for forward pricing purposes. To enhance inter-period consistency, CAS 9904.412 requires that assumptions be based on long-term expectations. Likewise, under CAS 9904.416, projected average losses must

[16] While a contractor can exercise certain freedom in determining its ''best estimate'' of future trends, other factors, such as historical trends, plan experience, industry trends, must be considered.

be actuarially determined on a long-term basis. Besides the concerns for consistency, post-retirement benefit plans probably will have to be based on long-term, ongoing commitments, in order for estimated liabilities to be considered valid.

The pension Standards have always required that assumptions be based on long-term, best-estimate, expectations. The recent amendments to the pension Standards followed the lead set by SFAS 87 and ERISA by requiring that each assumption be individually identified and reasonable. The CAS pension and insurance Standards do not impose any requirements on the selection of assumptions beyond that of long-term reasonableness.[17] The revised CASB Disclosure Statement, DS–1, asks contractors to ''describe the events or conditions for which significant actuarial assumptions are made for determining the cost accrual.'' The elicited information is not the current numeric values of the assumptions, but rather the accounting practice(s) used for determining these numeric values. Conversely, SFAS 87 and SFAS 106 set forth general guidance on the basis for selecting the discount rate. In CAS 9904.414, ''*Cost of money as an element of the cost of facilities capital*'', the Board requires that a contractor use ''interest rates specified by the Secretary of the Treasury pursuant to Pub. L. 92–41 (85 Stat 97)''. CAS 9904.415 also requires that the present value of deferred compensation awards be valued using the Treasury rate.

There is ample precedent for the Board to consider mandating a specific interest rate.[18] Furthermore, there has been limited funding of post-retirement benefit plans so that there are often little or no assets from which to derive meaningful historical rates of investment return or against which the reasonableness of the assumption can be gauged. Most of the assets, if any, will be accumulated from future contributions. There may be a need to set forth the basis for selecting the interest assumption or even mandate the use of a specific rate. If such a requirement is deemed desirable, the issue may be whether the basis for determining the rate or the rate itself should be prescribed. Possible candidates for a mandated rate could be the contractor's internal rate of return or the CAS 9904.414–50(b) Treasury rate. Another possibility is to reference a hypothetical bond portfolio similar to the SEC's requirement for SFAS 87 disclosures that the rate be based on a portfolio of bonds rated ''Aa'' or better.[19]

Many other assumptions address the same contingencies as pension assumptions. Often the same employee population is covered by both the pension and the post-retirement benefit plan. It may be desirable to require that population assumptions about events and conditions that are common to both plans be the same, or at least consistent and reconcilable. Similarly, there are economic and non-population conditions and events, such as general inflation and plant closings, that apply equally to both types of plans. Again, there should be consistency between the assumptions used to measure pension costs and post-retirement benefit costs.

Certain assumptions are unique to post-retirement benefit plans.[20] This is particularly true of retiree health care benefits. One of the primary findings of the Coopers and Lybrand field test of the SFAS 106 exposure draft was the lack of statistically reliable benefit data. Most census data only identified the employee and did not include information on spouses, children, and other dependents. To further complicate matters, benefit payment records often did not identify whether the recipient was active or retired, the employee or the dependent, Medicare eligible or not. While the situation has greatly improved as companies have upgraded their data systems in response to SFAS 106, the newness of reliable databases combined with frequent changes in the benefit structure limit the usefulness of companies historical data for predicting future trends. However, unlike the interest assumption, the CASB staff is unaware of any alternative basis for projecting benefit payments.

A final consideration is the responsibilities of the actuary and the contractor. Since the actuary is not a party to the Government contract, CAS 9904.412 and 9904.413 have always imposed the responsibility for selection of actuarial assumptions on the contractor. The actuary is a paid consultant of the contractor. The contractor defines the scope of work and can thereby exercise significant control over the actuary's work product. Nevertheless, some have suggested that the actuary's post-retirement benefit cost and liability measurements be subject to generally accepted actuarial principles and practices as promulgated by the Actuarial Standards Board (ASB), an independent body within the American Academy of Actuaries. Thus, if a contractor instructs an actuary to value the post-retirement benefit plan with assumptions that the actuary believes are unreasonable, the actuary would have a professional obligation under ASB principles and practices to disclose that fact, although probably counter to the client's wishes.

A difficulty may arise when a contractor's ''best estimate'' materially differs from his professional actuary's ''best estimate'', but falls within a range the actuary can accept. Legitimate differences in expectations concerning the future should not pose a problem. But, procuring officials and auditors have expressed concern that a contractor, rather than designating use of its ''best-estimate'' assumptions, has selected assumptions advantageous to maximizing cash flow or for creating artificially low costs to be used in competitive negotiations. This concern is greater with retiree health care benefit liabilities that can be more sensitive to minor changes in assumptions. The CASB staff notes that SFAS 106 and Actuarial Standard of Practice Number 6 both require a sensitivity analysis of the assumptions used for post-retirement benefit costs.

Issue 35: Should actuarial assumptions for on-going post-retirement benefit plans be based on long-term, ''best-estimate'', expectations as they are for pensions?

Issue 36: Should a change in the basis used to set actuarial assumptions be treated as a change in cost accounting practice?

Issue 37: Should the Board require a certification that the actuary's selection of assumptions, measurement of the liability, and assignment of cost to periods are in compliance with generally accepted actuarial practices and principles as promulgated by the Actuarial Standards Board?

Issue 38: Should the CAS Board require a sensitivity analysis of the assumptions?

a. If yes, should there be specific pass/fail criteria?

b. If no, what criteria, if any, should be used to evaluate the validity of an actuarial assumption?

[17] Except where a loss has occurred but payment is deferred. (See CAS 9904.416–50(a)(3)(ii)).

[18] For purposes of this Staff Discussion Paper, terms such as ''interest rate'', ''discount rate'', or ''investment earning rate'' are treated synonymously referring to the interest assumption, except where the context clearly indicates otherwise. The interest assumption is the rate used to reflect the time value of money in present value calculations.

[19] See SEC letter dated September 22, 1993 to Mr. Timothy S. Lucas of the FASB.

[20] See paragraph 5.5.2 of Actuarial Standard of Practice No. 6, ''*Measuring and Allocating Actuarial Present Values of Retiree Health Care and Death Benefits*'', for a partial list of possible assumptions. As used in this statement, the term ''allocation'' refers to the process of assigning portions of the liability to accounting periods. Actuarial standards of practice do not address the allocation of costs to final cost objectives.

Topic G. The need, if any, to Substantiate Accruals by Funding

As with pension costs, there is an extended delay between the cost assignment of and the actual payment of the benefit liabilities. Unlike pensions, there is a greater degree of uncertainty in the estimation of the liability and there are fewer opportunities to prefund post-retirement benefit costs on a tax-advantaged basis.

Once the concern of what is a post-retirement benefit plan for cost accounting purposes is settled and criteria for accrual accounting are established, the Board will have to address an even more difficult topic—the need, if any, for a funding requirement. Post-retirement benefit plans are more comparable to nonqualified than to qualified pension plans, and therefore the Board may have to address many of the issues that arose in the pension case in the case of post-retirement benefit costs, as well. The Board's decisions in this area will have to be consistent or reconciled with the decisions regarding nonqualified pension plans.

(i) The Need To Substantiate

Several contractor representatives have opined that no action on post-retirement benefits is preferable to a funding requirement and noted that they had been able to negotiate equitable agreements with Contracting Officers concerning accounting for post-retirement benefit costs. But such individual arrangements with contractors defeats the goal of uniformity. Another concern is the effect of a funding requirement on competition, since the ability to use tax-advantaged funding could vary greatly between contractors and because some contractors who have been funding their post-retirement benefits will have much lower costs.[21] Many in the contracting community believe that post-retirement benefit liabilities are valid liabilities and therefore a funding requirement is not needed. They note that there would be substantial administrative expenses associated with establishing and maintaining a fund. They do concede it is reasonable to have an adjustment mechanism so that the Government can recover any prior period post-retirement benefit costs, which were priced into contracts, whenever a post-retirement benefit plan is terminated.

Many procuring agency representatives firmly believe that funding is still necessary to protect the Government's interest, especially given the dollar magnitude of post-retirement benefit plan costs, the degree of uncertainty, and, as with pensions, the extended delay between the employment service that creates the liability and the benefit payment that liquidates the liability. From an accounting point of view, the need to substantiate long-term liabilities applies to post-retirement benefits as much as it does to accrued pension costs under CAS 9904.412 and to prefunded retiree insurance costs under CAS 9904.416. There is also the question of public policy that suggests to many a careful scrutiny of any funds advanced to contractors through accrual accounting of post-retirement benefit costs on an unrestricted basis.

At first blush, it would appear that consistency with the pension Standards could be achieved using the tax-rate complementary funding requirement for nonqualified plans, which are most similar to post-retirement benefits. However, some Government representatives are still not comfortable with the tax-rate complementary funding concept for nonqualified pension plans, but have accepted the notion because these nonqualified plan liabilities are still relatively small compared to those of qualified pension plans. They might find the tax-rate complementary funding approach difficult to accept for estimated liabilities of the magnitude associated with post-retirement benefits. Some actuaries with clients who are Government contractors observe that there has been little interest in using complementary funding for nonqualified pension plans. Many express a belief that complementary funding adds an element of complexity without utility.

In addressing the funding issue, it may be advisable to avoid any direct connection to the Internal Revenue Code (IRC). Unlike pensions where the bulk of the liability is associated with qualified pension plans whose trusts are tax-exempt and whose contributions are tax-deductible, the opportunities for tax-advantaged funding of post-retirement benefit plans is essentially limited to VEBA trusts and IRC § 401(h) separate accounts. Considering that the tax-advantages of non-union VEBA trusts were drastically reduced in the early 1980s and that the tax-advantages of qualified pension plans have been somewhat reduced, any funding requirement that is tied to the IRC would have to be flexible enough to handle possible future restrictions as tax policy changes. In fact, it remains arguable whether tax-consequences should be a concern in developing an accounting standard.

Although at present there is only limited funding, if any, of post-retirement benefit plans, any imposition of a funding requirement might consider the need for a limit on the accrual of post-retirement benefits similar to the CAS 9904.412 ''assignable cost limitation''. Such a limitation would prevent over-funding once fully adequate assets had been accumulated. And, to be consistent with the period assignment rules for pensions, any assigned cost, and associated interest, that was voluntarily not funded might be explicitly eliminated from contract costs in future periods. Likewise, funding in excess of the assigned cost might be carried forward, with interest, until needed in future years.

Issue 39: Is funding necessary to substantiate accrual of costs for the estimated liability for post-retirement benefits? If so, what level of funding is necessary?

Issue 40: Because assets are an integral part of cost measurement under most actuarial cost methods, how should the unfunded portion of the cost accrual be accounted for if funding for all or some portion of the accrued cost of a period is not required?

Issue 41: Should a Standard addressing Government contract costing consider the tax consequences of its accounting rules? If so, should the Board consider tax-rate complementary funding similar to that in CAS 9904.412?

Issue 42: Should there be an ''assignable cost limitation'' similar to that found in CAS 9904.412? Should such a limitation be defined differently for post-retirement benefit costs?

(ii) Funding Vehicles

There are two types of VEBAs: union and non-union. The earnings of a union VEBA are tax-exempt, but the earnings of a non-union VEBA, like those of a ''rabbi'' trust, are subject to the unrelated business income tax (UBIT). For consistency with the amendments to the pension Standards, the Board may wish to consider treating UBIT taxes on the earnings of a non-union VEBA trust as an administrative expense of the fund.

Another issue is which investment vehicles should be recognized as assets for funding purposes. Contractors and their actuaries report that use of Trust Owned Life Insurance (TOLI) arrangements and Corporate Owned Life Insurance (COLI) arrangements is rare for retiree health care benefits. They indicated that use of ''rabbi'' trusts for

[21] The concern with contract cost difference due to cash accounting versus funded accruals is related to the topic of permitting multiple accounting methods previously discussed under Topic B.

post-retirement benefits was somewhat rare and only knew of one contractor who used a secular trust for post-retirement benefits. The use of IRC § 401(h) accounts and VEBAs in combination are somewhat common. They did note that accruals for bargaining unit plans can often be fully funded using a union VEBA. And, the larger the Government business base, the more likely a contractor is to establish means of funding post-retirement benefit costs in order to use accrual accounting for contract pricing.

Any consideration of post-retirement benefit investment vehicles should address the nature of IRC § 401(h) accounts. ERISA permits a qualified pension plan to provide retiree health care insurance benefits through a tax-qualified trust provided that such benefits are ancillary to the basic retirement benefit and the contributions for 401(h) health benefits are accounted for separately from other pension benefits. It is noteworthy that ERISA does not impose this separate accounting requirement for other ancillary benefits such as disability income and life insurance. Many have suggested that this separate accounting provision distinguishes post-retirement health care benefits from benefits that can be considered to be ''an integral part of the pension plan''. A decision may be desirable as to whether, for Government contract cost accounting purposes, an IRC § 401(h) account is an integral part of a pension plan, and thereby subject to CAS 9904.412 and 9904.413, or is a form of post-retirement benefit plan asset subject to a Standard dealing with post-retirement benefits.

For both CAS 9904.412 and 9904.416 purposes, the funding arrangement must be either in the form of a trusteed fund or a reserve maintained by an insurer. For consistency, any funding provision for post-retirement benefits probably should require that the assets be maintained either by a trustee in a fund or an insurer in a reserve established for the exclusive purpose of providing post-retirement benefits. Also, given the abuses that have occurred in some qualified pension trusts and the proprietary nature of insurance company calculations, it may be desirable to require that the investments have a definitely determinable fair or market value. Such a rule may not have to apply to an insurer's statutory reserve associated with a bona-fide group or individual insurance contract subject to state insurance laws. The CAS 9904.416 provisions regarding captive insurers should also apply to a fund or reserve maintained or trusteed by an insurer.

Issue 43: Identify types of trust arrangements; e.g., IRC § 401(h) accounts, VEBAs, ''rabbi'' trusts, secular trusts, that should be considered? Is the Government's interest sufficiently protected by these trust arrangements?

Issue 44: Identify what insurance arrangements; e.g., insurance reserves, separate investment accounts, COLIs, TOLIs, should be considered? Is the Government's interest sufficiently protected by these insurance arrangements?

Issue 45: Should separate accounts established within a qualified pension trust for IRC § 401(h) health benefits be considered the assets of a post-retirement benefit plan or the assets of an ancillary benefit that is an integral part of the pension plan.

Issue 46: Can several types of funding arrangements be combined to form the assets of a post-retirement benefit plan? If so, is there a preference or priority order to the various types of funding?

(iii) Alternatives

Given the limited availability of efficient funding vehicles that would sufficiently protect the Government's interest, the CASB staff believes that an alternative means of substantiating the cost should be explored. Although most alternatives will not be as secure as a trusteed fund, the avoidance of administrative expenses and burdens may be a compensating factor.

One possibility would be to permit a very limited form of accrual accounting. This could be achieved by limiting or prohibiting projections of benefit growth in actuarial calculations. Considering the comments received by the CAS Board in response to the Staff Discussion Paper on ''*Accounting for Unfunded Pension Costs*'', 56 *Fed. Reg.* 27780, such an approach should recognize future vesting, especially since vesting often does not occur until full eligibility under many post-retirement benefit plans.

The Board may decide to not provide for the recognition of the initial unfunded liability.[22] If so, this may decrease annual costs sufficiently to mitigate the Government's interest in ensuring that the accrued costs are funded. This could be especially true if this treatment is coupled with a somewhat restrictive measure of the accrued cost.

Another alternative may be to require that a contractor obtain a surety bond to protect the Government's reversionary interests in the case of a plan termination or segment closing. The CASB staff questions whether such bonds are or would be available. Furthermore, if a contractor's financial situation were to deteriorate, the contractor may not be able to maintain the bond or afford the necessary premium at the point in time when the Government's reversionary interest is most at risk.

The alternatives set forth above are examples and are not intended to set any limits on alternative approaches. The staff encourages respondents to this Staff Discussion Paper to propose any other alternatives that they believe should be considered.

Issue 47: Can restrictions be placed on the actuarial cost method that would obviate the need to substantiate the accrual through a funding requirement?

a. Would the accrual recognition be sufficiently restricted by the use of the accrued benefit cost method?

b. Would the accrual recognition be sufficiently restricted if only current, that is, unprojected, benefit levels are considered?

c. Are there other actuarial cost method restrictions that should be considered as alternatives to a funding requirement?

Issue 48: If the initial unfunded liability is not recognized, would the need to substantiate the accrual through a funding requirement be obviated?

Issue 49: If all changes in actuarial liability are not recognized, except for experience gains and losses, would the need to substantiate the accrual through a funding requirement be obviated?

Issue 50: Would the purchase of a surety bond or other third party guarantee adequately protect the Government's interests in lieu of a funding requirement? Identify the types of guarantees that may be available and appropriate.

Issue 51: Are there other alternatives to a funding requirement that should be considered?

Topic H. Cost Determination for Segments

Once decisions are made on how to measure and assign to periods the costs of post-retirement benefit plans, the staff believes a review is needed of how such costs are determined at segments prior to their ultimate allocation to final cost objectives. GAAP is not concerned with the intra-period allocation of costs to cost objectives, so any consideration of how post-retirement benefit costs are allocated to segments needs to be addressed. Furthermore, the plan population or experience of a segment may be substantially different from that of the post-retirement benefit plan as a whole. In such instances there may be a need to treat that segment separately

[22] See Subtopic E(i).

from the rest of the post-retirement benefit plan.

(i) Allocation of Post-Retirement Benefit Costs to Segments

Post-retirement benefit plans may be established and costs accumulated at the corporate, home office, or segment level. Regardless of whether post-retirement benefits are viewed as pensions, deferred compensation, or insurance, if they are incurred at the home office level those costs would seem to be a central payment or accrual for CAS 9904.403 purposes. Moreover, post-retirement benefit cost calculations are based on employee census data so that portions of the home office post-retirement benefit expense often can be readily associated with the employees of individual segments. The fundamental requirement found at CAS 9904.403–40(b)(4) and the illustration at 9904.403–60(c), both of which specifically address pension and insurance costs, seem to provide the basic guidance regarding how post-retirement benefit costs could be allocated to segments. It can also be argued, however, that following the concepts and principles found in CAS 9904.403–40(a)(1), post-retirement benefit costs should be directly allocated to segments on a bases that reflects the appropriate beneficial or causal relationships.

The appropriate base used to allocate post-retirement benefit costs from the home office to segments may differ from that used for pensions or insurance. Post-retirement benefit costs often are not salary related and the allocation base used for pensions or other insurance may be inappropriate for post-retirement benefits. The CASB staff believes that special guidance, similar to that used for pensions found at CAS 9904.413–50(c)(1), may be needed to describe the appropriate base or bases for allocating post-retirement benefit costs to segments. Clearly any review of the allocation basis should consider both the accounting method used to measure and assign costs and the relationship of the benefits to the covered population. This review would have to consider how costs for a plan providing both flat benefit health care insurance and salary-related life insurance should be allocated. Note that this allocation question is similar to the one raised under Topic D concerning whether health care and life insurance benefits should be treated separately.

Issue 52: Does CAS 9904.403 provide adequate guidance on the allocation of post-retirement benefit costs from home offices to segments?

Issue 53: In addition to the current guidance in CAS 9904.403, is there a need for special guidance on the allocation of post-retirement benefit costs from home offices to segments?

Issue 54: What allocation base(s) are appropriate for post-retirement benefit costs?

Issue 55: Should the allocation base vary by type of post-retirement benefit; e.g., health care insurance, prescription drug programs [23], life insurance, retiree discounts?

Issue 56: Does the accounting method; i.e., cash accounting, terminal funding, or accrual accounting, affect the selection of the appropriate allocation base?

(ii) Separate Calculation of Segment Post-Retirement Benefit Costs

CAS 9904.413 and 9904.416 both require that segmented accounting [24] may have to be used to isolate to a segment costs attributable to that segment only. For consistency with the CAS pension Standards, and more importantly, to follow the CAS 9904.403 concept of directly allocating costs to the greatest extent practicable, a similar provision may have to be made for post-retirement benefits. Therefore, it may be desirable to require that when the demographics, risk factors [25], or experience of a segment are materially different from those of the post-retirement benefit plan as a whole, post-retirement benefit costs should be separately calculated, that is, measured, assigned, and allocated at the segment level. In such cases, a segment's accrual computations would also need to address the initial allocation of assets to a segment and the subsequent annual asset valuations. Certainly, if the population of a segment comprises the entire population of a post-retirement benefit plan, it would seem to be a basic requirement that costs be determined at the segment level. If other than accrual accounting is permitted, such a requirement may have to be extended so that cash accounting and terminally funded costs are directly charged to a segment based on the population that retired from that segment.

Issue 57: If the post-retirement benefit plan is established at the home office or corporate level, should post-retirement costs ever be separately calculated at the segment level?

Issue 58: If the post-retirement benefit plan covers only the employees of a particular segment, should the costs of the plan attributable to that segment be calculated, that is, measured, assigned, and allocated at the segment rather than at the home office or corporate level?

Issue 59: Should refunds and credits ever be accounted for at the segment level? If so, please describe the appropriate circumstances.

Issue 60: Should experience gains and losses ever be accounted for at the segment level? If so, please describe the appropriate circumstances.

Issue 61: Should segmented accounting be required if plan population or plan design factors affect one segment more or less than other segments? If so, please describe the factors that should be considered; e.g., mortality, morbidity, special benefit supplements, state insurance law.

Issue 62: Should contractors be permitted to establish special segments for retired or other inactive plan participants?

Issue 63: If funding is considered to be a prerequisite to accrual accounting, should the methods described in CAS 9904.413 be used to initially allocate assets to the segment and thereafter annually updated?

(iii) Funding of Government Segments Only

Some have suggested that contractors be permitted to fund only the post-retirement costs of their segments performing work under Government contracts if the contractor uses segmented accounting. This would permit contractors with predominately commercial business to account for and operate their commercial segments as they determine best for that environment.

Besides the concerns as to what constitutes a plan,[26] a practical problem would be how to design a trust document that would reserve the assets for the exclusive use of only certain employees of a plan. Pension and trust law generally view the trust fund as providing assets for all participants of a plan. The CASB staff questions whether any trust and plan arrangements could be developed that would permit segmented accounting and funding, other than establishing and maintaining a separate plan and trust for the

[23] Prescription drug costs can represent a very significant portion of the costs of a health care insurance program. It may be appropriate to treat such coverage separately from other health care benefits.

[24] As used in this Staff Discussion Paper, ''segmented accounting'' refers to the process of measuring, assigning to periods, and accumulating all or some elements of the cost at the segment level rather than at the home office level.

[25] There may be hazardous work performed at some Government segments that is not found in other Government and commercial segments.

[26] See subtopic B(ii) ''Different accounting methods for different benefit types''.

segment. Operating separate plans and trusts could be administratively burdensome.

In the preamble to the final rule on pension costing (61 FR 16534), the CAS Board, in permitting segmented funding of qualified pension plans, noted that while the assets of a plan are subject to the claims of all plan participants, the funding requirements and protections of ERISA would provide similar funding for all segments. However, the segmented funding option is not available to nonqualified pension plans because they lack the minimum funding requirements of ERISA. The funding of post-retirement benefit costs is an act that provides the plan participants with security and assurance that the deferred benefit will ultimately be paid. Many post-retirement benefit plans cover several segments so that all employees are eligible to earn the same benefit regardless of whether a particular segment performs Government work. However, the employees of segments performing Government work would have a greater level of security if only those segments are funded. Thus, there may be legal or employee relationship constraints on the establishment and funding of only those segments performing Government work.

Whether a separate trust is established for a given segment, the funds in the trust would probably not be directly available to a contractor if the Government is ever due a credit or other refund. Therefore, as with pensions, any credit or adjustment would come from general corporate resources. This use of corporate funds would be offset by the trust assets which remain available for the funding of benefits. Thus, the trust cannot directly provide the funds for any adjustment covering the Government's rights. Nevertheless, it may be possible for segmented funding of a plan-wide trust to be evidenced by memorandum records and to use general corporate resources for the adjustment. Because the plan assets are retained in the trust fund, the subsequent recovery of these corporate funds would occur through lower future post-retirement benefit contributions. If the use of such memorandum records is adequate to protect the Government's interest, then separate trust arrangements may not be necessary.

Others have pointed to CAS 9904.413–50(c)(9) and have suggested that contractors be permitted to establish separate retiree segments. Modeled after the insurance concept of a retired life reserve, a retiree segment can be a useful device whereby retirees are fully funded and removed from the active population that is performing work under Government contracts. Furthermore, if the CAS Board permits contractors to use different accounting methods for different plan populations, then permitting separate funding arrangements for those populations may be desirable. However, the concerns expressed above about segmented funding would apply to different funding provisions for different populations within the same plan.

Issue 64: If funding is considered to be a prerequisite for accrual accounting, is it desirable to fund only those segments performing work under Government contracts?

Issue 65: Can a trust arrangement be restricted so that only the benefits of plan participants of segments performing work under Government contracts are funded?

Issue 66: Alternatively, could an arrangement be developed whereby segmented funding is evidenced using memorandum records within a trust established for the post-retirement plan as a whole? Would such memorandum records be adequate to protect the Government's interests?

Issue 67: If separate funding is permitted, how should the assets attributable to employees transferring between funded and unfunded segments be treated?

Topic I. Accounting for Plan Terminations, Liability Settlements, and Benefit Curtailments

Under paragraph 103 of SFAS 106, changes that a company voluntarily makes to its post-retirement benefit plan that can be viewed as an extraordinary event; e.g., plan terminations and benefit curtailments, should be dealt with separately from normal modifications to the design of an ongoing plan. Because the estimated liabilities of post-retirement benefit plans can be dramatically affected by a variety of factors, the CAS Board may wish to consider if such changes require special treatment as some type of extraordinary event.

Although court decisions have somewhat limited a company's ability to eliminate or reduce benefits, contractors can make substantial changes to the benefits or even terminate a plan. GAAP, as represented by SFAS 88, SFAS 106, and APB 30, views such major and infrequent changes to the liability as extraordinary events.[27] These events; e.g., plan terminations and benefit curtailments, may require special treatment under certain conditions. CAS 9904.413–50(c)(12) and 9904.416–50(a)(1)(vi) require that a credit be allocated in the current contract period based on the amount that reverts; that is, is refunded, from the trust fund or reserve. CAS 9904.413–50(c)(12) extends this requirement to the gain that occurs when a plan is frozen or benefits are curtailed.

If benefits are curtailed or dramatically increased, as long as the contracting relationship continues and costs are computed for the plan, one possibility is to amortize the gain or loss as would be the case for other experience gains or losses or plan changes. This approach would cause the least disruption to the forward-pricing process. However, such gains and losses can be quite large. In an environment of a declining or an expanding defense business base, equity may be better served by either immediate recognition or accelerated amortization. Any proposed solution to large gains attributable to benefit curtailments must also address the treatment of large losses due to benefit improvements. Therefore, a company's post-retirement benefit liability that is tied to Medicare, will have to be adjusted as Medicare benefits change .

Because large changes in post-retirement benefit liabilities may permanently reduce or increase the liability and costs of the post-retirement benefit plan, it may be preferable to directly adjust contract costs and prices. Otherwise, if a contractor's fixed-price contract backlog was sufficiently great, the effect of a change which is attributable to prior period costs being over- or under-estimated because benefit changes could not be anticipated, may never be credited or debited to the Government.

If a plan is terminated or frozen, then no further costs will be computed for that plan against which an amortization installment can be credited. As long as the contracting relationship continues, the amortization installment credits could be reflected in ongoing contract costs and prices. But, because there would be no further calculation of costs for that post-retirement benefit plan, a mechanism to effect the adjustment would have to be developed. If a replacement plan is established, such a mechanism would prevent duplicate charges from being made for the same

[27] The termination of a plan, and possibly a major benefit curtailment, is a change in the accounting basis for the cost accrual; that is, the assumption that the plan is an ongoing, permanent undertaking has been negated. The CAS Board uses the 9904.413–50(c)(12) adjustment mechanism, rather than a reference to the CAS provision for accounting practice changes, because such an event is equated to the GAAP concept of an extraordinary event wherein the effect of the event on prior period costs must be fully recognized in the current period.

liability. Because there has been little funding of post-retirement benefit plans, the CAS Board is aware that an immediate period adjustment could result in a claim against the Government for a substantial unfunded actuarial liability.

A third type of extraordinary event that may require special treatment is that of a plant closing or major layoff. Post-retirement benefits do not have the same vesting rights as pensions; i.e., benefits are often not vested until the participant is eligible to retire. From an actuarial perspective, there could be a large termination of employment gain when there is a plant closing or massive layoff. However, the CASB staff presumes that such events would usually coincide with a segment closing. Nevertheless, this presumption may have to be examined further.

Finally, the CAS Board may wish to consider whether the gain or loss from a liability settlement should be treated separately from other asset gains and losses. Any special recognition or acceleration of amortizations would have to be balanced with the treatment of asset gains and losses and the treatment of terminal funding. In fact, since the majority of post-retirement benefit plans are currently unfunded or funded at minimal levels, these settlements are most analogous to terminally funding a previously unrecognized cost.

Issue 68: Should there be special accounting treatment for the effects of the termination of a post-retirement benefit plan? Should the treatment methodology be dependent on whether assets revert to a contractor?

Issue 69: Should there be special accounting treatment for the effects of a post-retirement benefit curtailment?

Issue 70: Should there be special accounting treatment for the effects of the settlement of post-retirement benefit liabilities?

Issue 71: Are there other non-recurring events that should be considered for special accounting treatment?

Issue 72: What methodology; e.g., immediate recognition or accelerated amortization, should be used for the special accounting of these extraordinary events?

a. Should the special accounting treatment differ depending on whether or not the contractual relationship with the Government continues?

b. If the effect of the extraordinary event is treated as an actuarial gain or loss, should the amortization of the gain or loss be accelerated?

c. Should the special accounting treatment apply if only one type of benefit is affected?

Topic J. Adjustments for Segment Closings

In the event a contractor closes a segment, issues regarding how the Government should recognize such events arise. Further, the resolution of this issue may influence how a contractor converts its cost accounting practice for post-retirement benefits from a cash to an accrual basis. Also associated with the issue of any adjustment for segment closings is how the initial unfunded liability is treated.

For pension costing purposes the CAS Board has defined what constitutes a segment closing (see CAS 9904.413). CAS 9904.413 has historically contained a provision requiring an immediate period adjustment of prior pension costs when a segment closing occurs. CAS 9904.416 focuses on typical insurance costs where the practice is to determine costs based on the risk exposure for the upcoming period only. CAS 9904.416 does not provide specific guidance on the recognition of surplus assets accumulated through the advanced funding of retiree insurance when a segment closes.

Any provision concerning treatment of post-retirement benefit costs when a segment closes will have to consider similar questions to those addressed in CAS 9904.413. These questions include: what constitutes a ''segment closing''; what is the appropriate adjustment method; and how should the adjustment amount be measured. Any answers to these questions should be consistent or reconciled with CAS 9904.413–50(c)(12).

As previously discussed, there has been little or no funding of the large liabilities of post-retirement benefits. If the concept, which is found in the pension Standards, that segment closing adjustments should cover both over- and under-funded plans is applied in the case of post-retirement benefits, it could immediately create large claims against the Government for unfunded post-retirement benefit liabilities previously not included in costs charged to or priced into contracts. Since neither contractors nor the Government sought the accrual of post-retirement benefit liabilities prior to the promulgation of SFAS 106, there is a question as to the appropriate adjustment recognition for such unfunded post-retirement benefit liabilities when a segment closes. And, there is the practical question as to whether Federal agencies would have budget appropriations available to fully cover contractor claims for these large unfunded liabilities.

Some may argue that to the extent the Government benefited by not recognizing the accrual of the liability and paid the lower costs that cash accounting produced, the Government bears some responsibility to see that funds are available to secure the benefits earned by long-term government contract employees. Acording to many, in *Remington Arms, supra,* the Government was held to a higher level of accountability than in many other contracting relationships because the Government was the owner and sole beneficiary of the operations at the GOCO. Furthermore, the special nature of a GOCO arrangement would have allowed the Government to influence the decision whether contract costs were recognized on a cash or accrual basis. In most other cases, where there has not been a long term special relationship and a contractor has made an independent financial decision to use cash accounting, many believe the Government has little, if any, responsibility for the unfunded post-retirement liability.

If accrual accounting is mandated, a reasonable solution may be a transition rule that phases in the recognition of these historically neglected unfunded liabilities. The period of the phase-in should be developed in coordination with provisions for the recognition of the initial unfunded liability. Such a phase-in may provide a balance between the Government's responsibility for increased costs for a mandatory accounting change and a contractor's practice of not recognizing these costs on an accrual basis in the past. The need for special treatment of any unfunded liability derives from the cumulative nature of post-retirement benefit liabilities and distinguishes them from most other costs.

If a contractor is permitted a choice of accounting methods and chooses cash accounting or terminal funding, many would argue that such an election would preclude the contractor from making any claims that the Government share in the unfunded actuarial liability when a segment closes. On the other hand, if accrual accounting is not permitted, the question then becomes what is the Government's responsibility, if any, for the lack of accrual recognition. However, it is difficult to imagine that accrual accounting for a valid liability would not be permitted. And if the liability was not found to be valid, that fact would seem to preclude any claim when a segment closes.

Several contractor representatives have asked that the CAS Board

specifically provide that any adjustment charge for unfunded post-retirement benefit liabilities may be used as an offset to any CAS 9904.413–50(c)(12) adjustment credit for overfunded pension plans. The CASB staff believes that this is not necessary. 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 9904.413–50(c)(12) pension adjustment that is equitable based on the facts and circumstances of the particular segment closing.

Finally, if it is decided that an initial unfunded liability is to be excluded from Government contract cost recognition, then that portion of the assets and liabilities which existed when accrual recognition began should be adjusted for interest and excluded from any segment closing adjustment. A similar, but more complicated, exclusion would be needed if all past service liabilities are excluded from cost recognition. The CASB staff notes that such exclusions could limit the need for an adjustment to simply an accelerated, immediate period adjustment of outstanding experience gain and loss amortization installments. In fact, if the effect of the outstanding gain and loss adjustment does not meet the materiality criteria in CAS 9903.305, there may not be a need for a segment closing adjustment for post-retirement benefits.

Issue 73: Should there be a segment closing adjustment for post-retirement benefit costs? Please explain. Is your answer dependent upon how the conversion, if any, from cash accounting to accrual accounting is handled?

Issue 74: Except for GOCOs, what degree of responsibility does the Government have, if any, for a contractor's past practice of not accruing the costs for post-retirement benefit?

Issue 75: If the Government does have some degree of responsibility, how should the Government recognize that responsibility?

Issue 76: Independent of the *Remington Arms* decision, what degree of responsibility, if any, does the Government have, if any, for a GOCO's past practice of not accruing the costs for post-retirement benefit?

a. How should the Government's responsibility in the case of a GOCO be recognized in any phase-in provision for a segment closing adjustment?

b. Are there any other special contracting relationships that should be considered for similar treatment?

Issue 77: If accrual accounting is permitted, but not mandated, would a contractor's election to use cash accounting or terminal funding preclude the use of accrual accounting to determine the adjustment for a segment closing?

Issue 78: If accrual accounting is not permitted, does the required use of cash accounting or terminal funding preclude the use of accrual accounting to determine the adjustment for a segment closing?

Issue 79: Should there be any explicit coordination between any segment closing adjustment provision for post-retirement benefit costs and the CAS 9904.413–50(c)(12) segment provision closing adjustment for pension costs?

Issue 80: If accrual accounting is permitted, should the treatment of the initial unfunded liability and other elements of past service liability be coordinated with any segment closing adjustment provision? If there is no Government contract cost recognition of the initial unfunded liability, is a coordinated segment closing provision still needed?

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