



SOCIETY OF ACTUARIES

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# Pension plans of government contractors

by Bernard Sacks

The world's largest purchaser of goods or services is the U.S. government. Purchases range from simple paper clips to sophisticated weapons systems. Most government purchases are made through competitive techniques. Essentially, the government prepares specifications and invites qualified vendors to submit bids; the lowest qualified bidder is awarded the contract. In such contracts, the price paid by the government is unrelated to the low bidder's costs. These procedures are not appropriate for all types of purchases. After all, it would be strange indeed for the government to have bid openings for, say, the Stealth bomber. For its more sophisticated purchases, the government must use other techniques.

For such purchases, which represent the majority of the procurement dollars, contract awards are based on a combination of technical competence and cost. In such contracts, the price is based on cost. These cost-based contracts may take various forms. However, they can be categorized into two major groupings: flexibly priced contracts (e.g., cost plus fixed fee), and fixed-price contracts (e.g., firm fixed price). Whichever type is used, the important fact to bear in mind is that the price is based on cost.

The question to be asked, then, is what is cost? The answer to this question is contained in Part 31 of the Federal Acquisition Regulation (FAR) and, for certain contracts, in Cost Accounting Standards (CAS). Although CAS is applicable to only certain cost-based contracts, the FAR is applicable to all such contracts. Not all of the CAS rules have been incorporated into the FAR, but some have, including CAS 412 and 413. These two standards, published in Title IV of the Code of Federal Regulations, set forth the accounting rules for defined-benefit pension plans.

These rules have been incorporated in the FAR. Thus, all companies that have cost-based government contracts and defined-benefit pension

plans must account for these plans in accordance with the requirements of CAS 412 and 413.

## Who is a government contractor?

One problem faced by actuaries is knowing which of their clients is a government contractor. It is generally easy to spot the large company that performs most or all of its work for the government.

A government contractor is any company with a cost-based contract. And, if that contractor has a defined-benefit pension plan, the costs for that contract must be accounted for pursuant to the requirements of CAS 412 and 413. It is essential, then, that actuaries inquire whether their clients have any cost-based contracts and, if so, become familiar with the requirements of CAS 412 and 413.

## CAS vs. FASB and ERISA

For most actuaries whose clients have defined-benefit pension plans, the clients will make a valuation based on the requirements of FAS 87. The actuary also will determine appropriate funding levels based on ERISA requirements. The two valuations that the actuary makes will satisfy the client's needs for both financial statement and income tax purposes. However, these valuations will not satisfy the client's needs for government contracting purposes.

When the CAS Board was in existence, it repeatedly held that the accounting procedure followed for financial statement or income tax purposes is not necessarily appropriate for government contracting purposes. This credo is especially appropriate for calculating pension costs. Thus, whatever costs or funding requirements are calculated for FAS 87 or ERISA purposes, separate numbers must be developed for CAS purposes.

It is clear, then, that for any client having a cost-based contract, the defined-benefit pension cost to be allocated to that contract must be calculated pursuant to CAS 412 and 413. It should be noted that the requirements of CAS 412 and 413 are not compatible with the requirements of FAS 87. Accordingly, a separate valuation must be made for CAS purposes.

## Government pension cost problems

Once a CAS valuation has been made, the actuary's efforts are by no means completed. There are numerous heated disputes between companies and the government relative to how pension costs should be developed and adjusted. Many of these disputes hinge on interpretations of CAS 412 and 413. These standards have the full force and effect of law.<sup>9</sup> Although there is no longer a CAS Board, the standards are still applicable to government contractors; unfortunately, there is no board to interpret the standards.

The problems between the government and government contractors are too numerous and complex to discuss fully in this article. However, the following paragraphs set forth some major problem areas.

## Overfunded plans

CAS 412 sets forth how the amount of pension cost for a year shall be calculated. It also provides that in order for such amount to be allocated to a current year's contracts, the amount calculated must either be funded in that year (as defined by the Standard), or the funding must be compellable (e.g., required by ERISA).

Under CAS 412, a pension cost will likely be developed even though a plan is overfunded. Because nothing we are aware of could compel additional funding for an already overfunded plan, contractors can recognize costs only if the funding is actually affected. However, because of tax considerations, most contractors do not fund an already overfunded plan. This creates several problems. Some contractors (e.g., nonprofit institutions) may wish to fund their plans, but the government doesn't want to reimburse them for funding an already overfunded plan. Can the government make its position stick? (We think not.)

We believe that if a contractor does not fund a plan for a year, no pension costs have been incurred for that year for government contracting purposes. We believe also that if a CAS 412 calculation has been made and the amount calculated is not funded, such amount represents an actuarial loss

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## Contractors cont'd

and, pursuant to CAS 413, must be amortized over 15 years. The government is taking the position (through, in our opinion, a misunderstanding of a provision of CAS 412) that costs calculated for a year but not funded in that year can never be recovered. Thus, a contractor having an over-funded pension plan is penalized if the amount calculated pursuant to CAS 412 is (1) funded, or (2) not funded. Contractors rightly believe that the government's position is inequitable. They will need support from their actuaries to demonstrate the effect of such inequity.

Another problem relates to long-term fixed-price contracts. In such contracts, contractors must estimate their costs, including pension costs, over the life of the contract. The government is concerned that the contractor includes pension costs in the price of these contracts and, because the plan becomes overfunded, does not fund the plan for those years. In such an event, the government believes that the contractor has received a windfall profit. The government's remedy is to seek a voluntary refund or to try to prove that the contractor defectively priced the contract. If the latter course of action is successful, the contractor can face severe civil and/or criminal penalties. To avoid such problems in the future, contractors will have to obtain from their actuaries multi-year projections of (1) CAS 412 cost calculations, (2) ERISA funding status, and (3) likely funding requirements.

### Other problem areas

There are numerous other significant problem areas relative to pension costs. These problems relate to matters such as:

1. Terminated pension plans — The government believes it is entitled to all or part of the "profit" realized by the contractor. A problem relates to how the government's perceived share of the residual shall be measured.
2. Terminated divisions — Contractors often sell or close divisions that were working on government contracts. Pursuant to CAS 413, final accountings must be made. Such accountings often entail making actuarial valuations for the closed division to determine what its assets and liabilities would be, as if it had its own pension plan.
3. Unfunded plans — There are numerous problems in developing

costs for nonqualified excess benefit plans and plans providing for medical benefits for retirees. It should be noted that, under CAS 412, plans that provide medical benefits to retirees and defined-benefit pension plans must be treated as a single plan. These factors create many disputes, and future litigation is probable.

### Conclusion

It is fair to conclude that the single largest area of conflict between contractors and the government relates to the cost of defined-benefit pension plans (and health benefit plans). Many of these problems will be resolved only through protracted litigation. Others might be resolved when the newly legislated CAS Board is assembled. In either event, it is likely that the problems will persist into the foreseeable future. The actuarial community must take an active role in resolving these problems.

Bernard Sacks, CPA, is a Special Consultant with Price Waterhouse's Government Contractor Consulting Service. As a member of the Cost Accounting Standards Board, Sacks authored, among other things, the two Standards dealing with the accounting for pension costs.

### Attention: Enrolled actuaries

If you passed the EA-2 examination in 1977 or 1978, we may have significant information for you.

Under the old Fellowship examination system a candidate could not receive dual credit for both EA-2 and another Part 7 examination. In the Flexible Education System, one may receive credit for all of these examinations. Consequently, a number of Enrolled Actuaries could be close to Fellowship. In some cases, only one 20-credit course is needed. For further information, please call Pat Holmberg at 312-706-3527.

### In memoriam

Albert W. Anderson FSA 1936  
 Mark A. Brunell ASA 1982  
 Larry M. Cohen FSA 1974  
 Carl H. Fischer FSA 1952  
 Norman Harper FSA 1945  
 Geoffrey T. Humphrey \*ASA 1976  
 Renaud Longchamps FSA 1976  
 John N. Miniello ASA 1982  
 Henry P. Morrison FSA 1926  
 K. A. Usherwood \*ASA 1954  
 Douglas T. Weir FSA 1940  
 Charlie T. Whitley FSA 1969

## Change in election procedure

by Harold G. Ingraham, Jr.

At its October 1988 meeting, the following change in election procedure was approved by the Society's Board of Governors:

Prior to completion of the first ballot, the Committee on Elections will recommend to the Board of Governors that up to three designated Board seats be reserved for individuals in areas of interest and/or country of residence deemed underrepresented in relation to the total Society membership. If the recommendation is accepted, the committee will select — for listing on the second ballot — at least twice as many candidates as there are Board seats reserved for underrepresented areas.

Based on a review of the Board's composition for this year's election, the Committee on Elections has recommended and the Board has approved at its January 1989 meeting reserving one designated Board seat for an individual specializing in health insurance and one additional designated Board seat for a pension specialist. Area of employment — whether insurance company, consulting or otherwise — is immaterial.

The Board election will follow normal procedures for the second ballot. After the ballots have been tabulated, the committee will determine whether the designated number of candidates for the earmarked categories would be elected through the normal process. If not, the committee would declare qualified candidates who have the highest number of votes to be elected to the reserved seats. The remaining Board seats would be filled by candidates with the most votes.

An example might clarify this new procedure. Let's suppose that six Board seats are open (as there will be in 1989). As indicated above, two of those seats are to be filled by a health actuary and a pension actuary. The committee will be required to include at least two health actuaries and two pension actuaries on the second ballot. The committee might well include more in each category.

Now suppose in the tabulation of ballots, one health candidate places third, one sixth, with others farther

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