SOCIETY OF ACTUARIES

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Thanks, Dan

(Ed. note: Daniel F. Case, Actuary with the American Council of Life Insurance, is resigning as an Associate Editor of The Actuary *after three years of service.* Actuary *Editor Linda B. Emory wrote the following letter of thanks to him.)*

On behalf of the entire Editorial Board of *The Actuary,* I would like to thank you for your contribution as Associate Editor for these past three years. You have solicited meaningful articles, edited them, edited other contributions to your issues, proofed the articles and features, and have never missed a deadline. You have also served us well on the Publications Policy Committee. You have fulfilled the commitment that you made to the new format of *The Actuary* so admirably and capably that you have been one of the principal reasons that the newsletter has succeeded in its current form. Yours was the first issue in the new format, and you set the standard for all subsequent issues. You will be sorely missed.

Life companies cont'd

some of these may be helpful to those considering some type of transactions.

- Overpaying – In a rush to "do a deal," or on the basis of inappropriate advice, too high a price may have been paid. In cases where debt was used to finance the acquisition, statutory earnings may not be sufficient to service it.
- Strategic misfit – Often, anticipated synergies between the organizations do not materialize. Reasons could be distribution related (no overlap), geographical, administrative, or economical. When this happens, intangible assets acquired are frequently not worth the price paid and subsequent divestiture results.
- Administrative complexities – If lowering unit costs is a major goal, systems involvement is critical. Assessments must be made to determine the cost and time frame for making necessary conversions.

  A number of transactions have been severely hampered by the inability to capitalize on the cost savings that were anticipated and occasionally paid for. The addition of new lines of business requiring sophisticated administration has been particularly troublesome.
- Adverse experience – Even though the risk of adverse experience can be priced, poor experience has caused disastrous unanticipated results. Most of these cases have resulted from health and accident lines, usually in a "down cycle."
- Overacquiring – Occasionally, organizations have made too many acquisitions in too short a time, spreading management too thin. One acquisition should be "digested" prior to embarking on the next, allowing the organization to determine how the pieces fit into the overall game plan.
- Distressed targets – This category of potential problems includes political cases as well as financially troubled companies. Although a price exists to make these transactions attractive, additional planning and discussions with insurance departments are required. In some cases a bail-out of a problem case would be considered a favor to the regulators. Frequently, the reputation of a troubled company is difficult to dislodge, so adverse lapse and sales results could be anticipated.

Conclusion

Consolidation will be a positive step for the life insurance industry. Hopefully, it also will benefit the consumer by lowering costs and strengthening the companies with which they do business. If organizations can focus on requisite critical success factors and avoid the pitfalls, we can avoid some problems that have plagued other industries and become a more efficient and profitable industry.

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Pension plans of government contractors

by Ronald L. Solomon, Eric H. Shipley, James E. Norris and Patrick E. Ring

The article by Bernard Sacks in the April 1989 issue of *The Actuary* presented an overview of how pension costs for work performed under a government contract are reimbursed. He pointed out the concerns of those involved in government contracting: overfunded plans, asset reversions from terminated pension plans, terminated divisions, and unfunded plans. We would like to expand upon some of these issues.

Pension cost, expense and contribution

The original Cost Accounting Standards Board (CASB) was aware of the distinction between the principles of good accrual accounting and the reality of how plans were actually funded. CAS 412 and 413 were developed contemporaneously with the Employees Retirement Income Security Act (ERISA). The ERISA standards, which governed the funding of pension plans, and the accounting standards (Opinion Number 8 of the Accounting Principles Board), which governed the pension expense shown on financial statements, were reasonably consistent; in fact many corporations used their contribution as the accounting expense. The CASB was able to walk the tightrope between the comparability and consistency goals of financial accounting and the funding goals of ERISA. From a contracting point of view, a meld of the correct period cost with the deposit to a fund was an ideal situation.

The result, however, was that the pension cost, computed under CAS 412 and 413, for a contract was neither the ERISA contribution nor the accounting expense. Furthermore, during the 1980s, when funding standards and accounting standards increasingly diverged, there was no CASB to ensure that the government's procurement rules reflected the changing environment. FASB's Statement 87 emphasized standardization in the measurement of pension expense to promote comparability.

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Pension plans cont'd

Meanwhile, funding requirements have changed in response to congressional concerns with deficit reduction and micro-management. And, many pension plans have gone from a period of inadequate funding and poor investment performance to large investment gains and the build-up of large surpluses. Until the newly reinstituted CASB begins functioning, the conflicts between contract reimbursement, funding and accounting will continue.

Overfunded pension plans

The most prevalent problem associated with "overfunding" arises when contributions to a plan become restricted by the full funding limitation. Currently CAS 412 and 413 do not modify the pension cost to reflect the full funding limitation. The Federal Acquisition Regulation (FAR) requires that the pension cost computed under CAS must be funded in order to be reimbursable. Therefore, a contractor can compute a pension cost in accordance with CAS but compute a lesser, even zero, contribution under ERISA. The contractor must then choose between funding the CAS pension cost and incurring a nonreimbursable excise tax, or not funding the CAS pension cost, thereby facing a permanent disallowance of that cost. Meanwhile, government auditors, who must apply the rules as they are written, find they must disallow costs that the contractor has incurred in fulfilling a contractual commitment. The argument has been made that the traditional pre-OBRA 87 full funding limitation is an integral part of any funding method. The new OBRA 87 full funding limitation adds another wrinkle, and reminds us that the CAS cost is defined by period accounting and by funding, but not by tax policy. A regulatory change to the CAS appears to be the best solution.

Asset reversions from terminated pension plans

Under contracts that reimburse costs, the government directly participates in the accumulation of pension assets. When a plan is terminated and surplus assets revert to the sponsor, the government expects to participate equitably in the reversion. If the terminated plan is replaced by an identical plan, future pension costs will be inflated by the additional contribution needed to replace the surplus funds that were removed. Regardless of whether the plan is replaced by an identical or by a less generous plan, the surplus assets become available for purposes other than the provision of pension benefits. Unless the government receives its equitable share of the reversion, money that the government had entrusted to the contractor to provide pension benefits earned for work in furtherance of the contractual goal can be diverted to other corporate goals wholly unrelated to the contract. Most of the reversion controversy surrounds negotiated fixed-price contracts. As Sacks so clearly states about these contracts, "the important fact to bear in mind is that the price is based on cost." The government's position is based upon that important fact. Since the circumstances and the pension promise in effect at the time the price was negotiated have been unilaterally modified by the plan termination, an adjustment is necessary to reflect the new circumstances and new pension promise.

Terminated divisions

Often at the end of a contract the corporate division that was producing the product or service is closed and the employees are laid off. When this happens an actuarial gain occurs because of the higher level of turnover. But, there are no future periods left under the contract in which to recoup the gain through the normal amortization process. In the case of a typical large defense contractor there are usually other new and ongoing contracts through which the government can participate in the gains. In the case of a contractor who has few or no other government contracts, or whose contract business is dramatically shrinking, the government's share of the gain would not inure to the government. Thus CAS 413 provides for a final accounting computed as if the division had its own separate plan that had terminated.

Unfunded plans

The CAS as drafted in the mid-1970s reflects an environment where all plans fell into one of two types – those that maintained a qualified trust fund and those few supplemental executive perquisite plans that were totally unfunded to avoid tax implications for the participants. The evolution of Rabbi and secular trusts coupled with the repeated decreases in maximum benefits allowed under section 415 of the IRS Code have resulted in the increasing popularity of nonqualified plans. Unfortunately the CAS chose the term "pay-as-you-go" to describe nonqualified plans, but an executive perquisite or excess plan using a Rabbi trust is neither a "pay-as-you-go" plan nor a qualified plan. This crack in the coverage combined with the funding requirements of the FAR has already created numerous problems for both the government and the contractors.

Furthermore, as the government and contractors wrestle with the FASB exposure draft on Post-retirement Benefits Other Than Pensions, they find that neither the CAS 412 pension (post-retirement) coverage nor the CAS 416 coverage on insurance costs is adequate. Sacks's comment on retiree medical plans is misleading because CAS 412 addresses only plans that are supplemental to the defined-benefit plan and not one that creates a separate and distinct benefit obligation which only coincidentally covers the same employee group.

Understandably, the government wants assurance that a cost that it reimburses now for a specific future contingent purpose will indeed be used for that purpose and that any investment returns on advanced-funded government dollars will be used to offset future government, not contractor, costs.

Conclusion

The original CASB wrote an excellent and comprehensive set of standards, and while it was in existence made great efforts to stay abreast of legislative and accounting changes. The problems that have subsequently emerged have come about largely because the pension environment has changed so dramatically while the CAS has remained unaltered since 1980. With the increased attention drawn to professional standards by the recent promulgations and exposure drafts of the Actuarial Standards Board, the FASB, and the GASB, we hope the new CASB will quickly become operational and will succeed equally well at updating the standards applicable to government contracting, leaving the government and contractors free to concentrate on their real goals of cooperatively providing America's human services, energy, and defense.

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