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FEATURE COMMENT: A Retrospective On The CAS 412 And 413 Rewrite

Today marks the 10th anniversary since the Cost Accounting Standards Board (CASB) issued sweeping changes to Cost Accounting Standards (CAS) 412 and 413, involving composition, measurement, adjustment and allocation of pension costs. 60 Fed. Reg. 16,534 (March 30, 1995). During the past decade, the subject of accounting for pension costs has been controversial and has produced much litigation. The purpose of this FEATURE COMMENT is to provide an overview of the history of pension cost accounting under the CAS rewrite.

The following discussion addresses several topics. First, this FEATURE COMMENT provides a brief history of the original promulgation of CAS 412 and 413. Second, the discussion addresses pension cost accounting issues prior to the March 30, 1995 rewrite. Third, this FEATURE COMMENT summarizes the changes to CAS 412 and 413 as a result of the 1995 rewrite. Fourth is an exploration of the many issues raised and resolved since the rewrite. Not surprisingly, there will be substantial focus on the subject of segment closures under CAS 413. Finally, the discussion contemplates those aspects of CAS 412 and 413 that will present further issues involving compliance.

A Brief History of CAS 412 and 413—The CASB promulgated CAS 412 (in 1975) and 413 (in 1977) in the wake of the Employee Retirement Income Security Act of 1974 (ERISA). Additionally, the Accounting Principles Board (APB) set

forth generally acceptable accounting principles in accounting for pension costs with its Opinion No. 8, and was in the process of re-evaluating that Opinion. The CASB believed that ERISA and APB Opinion No. 8 did not effectively address Government cost accounting. Regarding ERISA, the CASB explained that it “does not provide for the measurement of pension costs for assignment among cost accounting periods or for the subsequent allocation of such costs to contracts.” 40 Fed. Reg. 43,873 (Sept. 24, 1975), reprinted in Cost Accounting Standards Guide (CCH) ¶ 4258 at 5225–5226. The CASB criticized APB Opinion No. 8 as designed for financial accounting purposes that were inappropriate for Government contract costing. Accordingly, the CASB issued two standards that dealt extensively with the details of measuring pension cost, including the composition of pension costs and the allocation of pension costs through the assignment of actuarial gains and losses. *Id.* See Thomas Lemmer, Janice Davis & Paul Pompeo, *Pension & Postretirement Benefit Costs: Recent Developments*, 92-6 Briefing Papers (May 1992 & Supp.) (general overview of pensions in Government contracts).

Cases and Issues Prior to the Rewrite—After promulgation of CAS 412 and 413, there was little to no development in the area of pension cost accounting. In part, this was due to the robust economy in the 1980s and the proliferation of pension assets. To the extent that pension plans were fully funded, contractors would not have to make contributions to pension plans or would not have to make significant contributions. Similarly, when contractors make no employer contributions, there are no pension costs allocated to Government contracts. Ergo, the Government would not be sensitive to compliance issues with CAS 412 and 413. Additionally, changes in the tax code during the mid-1980s, including an excise tax for contributions in excess of the maximum tax-deductible amount for qualified plans and restrictive full-funding limits for determining the tax-deductible amount, inhibited contractors from funding pension plans in excess of the maximum tax-deductible amounts.

Furthermore, CAS 412 and 413 are among the more sophisticated CAS, and at a time when CAS 412 and 413 were new (as were ERISA, the Pension Benefit Guaranty Corporation and the emerging body of pension law), it was somewhat understandable that allegations of noncompliance with CAS 412 and 413 did not abound, even though the Defense Federal Acquisition Regulation Supplement (DFARS) required semiannual Contractor Insurance and Pension Reviews of large contractors up to 1998. DFARS 242.7302(b) (1998).

Nevertheless, as the 1980s progressed, contractors and the Government alike saw mounting asset surpluses in defined benefit pension plans. Contractors sought to acquire surplus assets through plan terminations under ERISA, and the Government started a movement to obtain what it deemed to be its fair share of any pension surplus. See *NI Indus., Inc.*, ASBCA No. 34943, 92-1 BCA ¶ 24631, recon. denied, 92-2 BCA ¶ 24980 (providing a thorough discussion of the Government's concerns about pension surpluses in the mid-1980s); see also Norman Stein, *Reversions for Pension Plans: History, Policies, and Prospects*, 44 Tax L. Rev. 259 (1989). Accordingly, the Government looked to CAS 413.50(c)(12) as a means to recover surplus assets from plan terminations. In *NI Indus.*, the contractor terminated a defined benefit pension plan and, following the terms of ERISA and implementing regulations, recovered the surplus assets and declared them as income. The Government alleged, in part, that the plan termination constituted a segment closure under CAS 413.50(c)(12). At the time, CAS 413.50(c)(12) provided that

[i]f a segment is closed, the contractor shall determine the difference between the actuarial liability for the segment and the market value of the assets allocated to the segment, irrespective of whether or not the pension plan is terminated. ... The difference between the market value of the assets and the actuarial liability for the segment represents an adjustment of previously-determined pension costs.

The Armed Services Board of Contract Appeals held that a plan termination does not constitute a segment closure and that the CAS did not address plan terminations at all. Having so concluded, the ASBCA did not interpret the effect of CAS 413.50(c)(12).

An unlikely venue, a bankruptcy court in Central Florida, prophesied what was to become a contentious issue in pension cost accounting: whether the sale of a segment constitutes a segment closure under CAS 413. *In re Bicoastal Corp.*, 124 B.R. 593 (Bankr. M.D. Fla. 1991). The Government filed a claim in the bankruptcy proceeding asserting, in part, entitlement to excess pension assets pursuant to CAS 413.50(c)(12) due to the sale of the debtor's subsidiaries. The court held that, although the sale of stock of the debtor's subsidiaries was of no consequence, the

sale of the stock coupled with the undisputed fact that the Debtor no longer has anything to do with the contracts assumed and performed by its former subsidiaries, and coupled with the effective termination of the retained pension and retirement plans leaves little doubt that these segments were closed.

Bicoastal at 598. Thus, the bankruptcy court opened the door to a theory for recovery of pension assets under CAS 413.50(c)(12).

The 1995 Rewrite of CAS 412 and 413—As the application of CAS 412 and, particularly, 413 was beginning to become contentious, so too was the process for promulgation of the revisions to those CAS. In comments from the American Bar Association (ABA) on the Notice of Proposed Rulemaking (NPRM), the ABA cautioned the CASB to issue a second NPRM rather than a final rule, due to the sweeping changes proposed in the various steps of the rulemaking process. Letter from Kinlin to Loeb (Jan. 4, 1994). Indeed, the final rule was a dramatic shift from any of the proposed rules.

A detailed discussion of the changes to CAS 412 and 413 is beyond the scope of this FEATURE COMMENT, and has been the subject of extensive contemporaneous analysis. See 37 GC ¶ 189; John McQuade and James Buss, *The New CAS 412 & 413: Significant Pension Accounting Changes*, Feature Article, 95-4 CP&A Report; and Roger Holbrook and Robert Metzger, "Segment Closing" Rules Under the New CAS 413: Implications for Contractors, Feature Article, 95-6 CP&A Report. Changes to CAS 412 reconciled a pre-existing conundrum involving the ERISA full funding limitation and pension cost allocation. The revision to CAS 412 established a four-step process for the computation of pension costs. CAS 412 imposed new rules on the allocation of pension costs for nonqualified plans. Finally, the CASB issued ex-

tensive amendments to the controversial segment closure provisions of CAS 413 by defining a segment closure (CAS 413.30(a)(20)), applying segment closure accounting to plan terminations and curtailment of benefits (CAS 413.50(c)(12)), and setting forth the methodology for calculating the adjustment to previously determined pension costs (CAS 413.50(c)(12)(vi)). Among the numerous examples is one that contemplates a Government share of any pension deficit. Of course, the changes to CAS 412 and 413 engendered as many problems as they solved.

Applicability of the CAS, Old Versus New: CAS 412 and 413 provide that the 1995 rewrite is effective March 30, 1995, but applies to contractors in the first cost accounting period following award of a contract or subcontract to which the revised CAS apply. For contractors who experienced segment closures, the Government argued that the revised CAS 413 applied once it was effective, regardless of whether the alleged segment closure occurred during the applicability of the original CAS 413. In the first case to address an allegation of noncompliance with the segment closure provisions of CAS 413.50(c)(12), the Government argued that the CAS 413 rewrite should apply to alleged segment closures arising from the sale of company divisions in 1987 and 1988. *Gould, Inc.*, ASBCA No. 46759, 97-2 BCA ¶ 29254, recon. denied, 98-1 BCA ¶ 29469; see Paul Pompeo, *Segment Closure Accounting Under Gould*, Feature Article, 97-9 CP&A Report. Alternatively, the Government argued that CAS 413.64(c), which purports to clarify the original CAS 413, effectively applied the CAS rewrite for purposes of compliance with CAS 413, regardless of the time of the alleged segment closure. See also *Teledyne Inc. v. U.S.*, 50 Fed. Cl. 155, 168 (2001), *aff'd*, *Allegheny Teledyne Inc. v. U.S.*, 316 F.3d 1366 (Fed. Cir. 2003), cert. denied, *General Motors Corp. v. U.S.*, 540 U.S. 1068 (2003). The ASBCA rejected the Government's positions and held that the original CAS 413 would apply to segment closures occurring prior to the effectivity of the CAS rewrite. *Gould*, *supra*.

The Court of Federal Claims followed the ASBCA by applying the original CAS to alleged segment closures occurring before 1995, and the CAS 413 rewrite to alleged segment closures in or after 1995. *Teledyne* at 175. In *Teledyne*, a contractor sought to apply the CAS 413 rewrite as an interpretation of the original CAS 413, to the extent that the CAS rewrite called for contractor recovery of a pen-

sion deficit in the case of a segment closure. *Id.* at 176. Furthermore, the court in *Teledyne* held that the CAS 413 rewrite applied to segment closures occurring after the rewrite became effective, regardless of whether that segment included CAS-covered contracts that pre-dated the CAS 413 rewrite. *Id.* at 186.

The CAS Rewrite Is Legally Valid: As discussed above, the ABA recommended that the CASB issue a second NPRM prior to issuance of the final rule because the rewrite incorporated sweeping changes that would not be the subject of sufficient public comment. Expanding on that theory, *Teledyne* argued that the CASB not only failed to follow proper notice and comment requirements, but the CASB also failed to comply with the Paperwork Reduction Act, Executive Order 12866 and the Regulatory Flexibility Act when promulgating the CAS rewrite. *Id.* at 188.

The Court of Federal Claims disagreed with *Teledyne* on all counts. Focusing mainly on the procedural dictates for promulgating a standard, the court held that the CASB had followed the proscribed steps to issue a final rule. The court dismissed the other arguments as lacking merit.

Triggering Events For Segment Closure Accounting: The original CAS 413 did not define an event that constitutes a segment closure. Under the original CAS 413, the ASBCA and courts uniformly concluded that the sale of a division constitutes a segment closure. As discussed above, the court in *Bicoastal* held that the sale of a subsidiary, resulting in no further contracts with the Government and retention of responsibility for the pension, was a segment closure. *Bicoastal* at 598. In *Gould*, the ASBCA held that sale of a division constitutes a segment closure, even though the division continued to conduct business under new ownership, because the segment had closed with respect to *Gould*. *Gould* at 145,438. Similarly in *Teledyne*, the court held that the sale of a segment constitutes a segment closure under the original CAS 413. Relying on the decisions in *Bicoastal* and *Gould*, the court held that, even though the segment continued to perform work under the new owner, the segment had closed as to *Teledyne*, because *Teledyne* retained responsibility for the pension and there were no further Government contracts against which the gains and losses attributable to the Government's share could be amortized. *Teledyne* at 170-171.

A mere plan termination, however, does not constitute a segment closure, as the ASBCA held in *NI Indus.* Other events that are not likely to be segment closures under the original CAS 413 include the completion or termination of a contract, a mere freeze in accrual of benefits and changes to pension plan provisions. See *Segment Closure Accounting Under Gould*, *supra* at 5–7.

The CAS 413 rewrite sought to define a segment closure and extend the segment closure accounting requirements to other events. CAS 413-30(a)(20) defines a segment closure as when “a segment has (i) been sold or ownership has otherwise been transferred, (ii) discontinued operations, or (iii) discontinued doing business or actively seeking Government business under contracts subject to this Standard.” Hence, the Court of Federal Claims recognized that the sale of a segment is an undisputable segment closure. *Teledyne* at 185. The CAS 413 rewrite also extends segment closure accounting to pension plan terminations, thus overcoming the holding in *NI Indus.* CAS 413.20(a)(14) defines a plan termination as an event where the plan ceases to exist and all benefits are settled, regardless of whether the plan is replaced by another plan. Furthermore, the CAS 413 rewrite includes the curtailment of plan benefits as an event requiring segment closure accounting. Apart from *NI Indus.*, neither plan terminations nor curtailment of benefits have been the subject of litigation. But see *Johnson Controls World Serv., Inc. v. U.S.*, 44 Fed. Cl. 348 (1999) (involving plan termination).

In *Viacom, Inc. v. U.S.* (No. 01-79C), pending before the Court of Federal Claims, Viacom contends that the completion of a contract is a segment closure when the segment was established to perform that contract, thus triggering the segment closure accounting and adjustments for a deficit in pension assets. The Government never issued a final decision on Viacom’s claim, either admitting or denying that the completion of the contract constitutes a segment closure. First Amended Complaint, *Viacom, Inc. v. U.S.*, No. 01-79C (Fed. Cl. Nov. 6, 2001). It would seem, however, that the completion of a contract in these circumstances constitutes a segment closure under either 413.50(a)(20)(ii) or (iii) because the segment has discontinued operations upon the completion of the contract and is no longer pursuing Government business.

The Impact on Fixed-Price Contracts: The Government has argued that CAS 413.50(c)(12) not only requires the inclusion of fixed-priced contracts for the computation and allocation of any adjustment, but also that the language requiring “an adjustment of previously-determined pension costs” actually requires an adjustment to the price of fixed-price contracts. Both the ASBCA and the Court of Federal Claims rejected this argument. In *Gould*, the ASBCA held that the plain meaning of an adjustment of cost means cost, not price. Thus, whereas the cost of flexibly priced contracts would be adjusted, the price of fixed-price contracts would not. An adjustment to flexibly priced contracts is recoverable under the Allowable Cost and Payment Clause and the Credits Clause of the FAR. Similarly, the Court of Federal Claims held that the plain terms of CAS 413.50(c)(12) do not provide for an adjustment to fixed-price contracts and that a price adjustment on fixed-price contracts “is not recoverable absent an express contract provision providing for that recovery.” *Teledyne* at 178.

The CAS 413 rewrite, however, included what the court described as a “significant change.” *Id.* CAS 413-50(c)(12)(vii) provides for an adjustment to both contract costs and prices, thus permitting “recovery by the government or the contractor of any pension surplus or deficit attributable to government pension plan contributions from both firm-fixed-price and flexibly-priced contracts.” *Id.* at 176. Accordingly, whereas segment closures occurring before 1995 would not include an adjustment to fixed-price contracts, those occurring after 1995 do.

The Impact on Pre-CAS or Non-CAS Covered Contracts: The Government has asserted that it is entitled to an adjustment of a pension surplus for all contracts, including those that pre-date CAS 413. The Court of Federal Claims held that an adjustment could only apply to a surplus or deficit attributable to contracts to which CAS 413 applies. *Id.* at 183–184. The court so concluded because the CAS apply prospectively, and extension to contracts that do not include CAS 413 would constitute a Government-mandated change in accounting practice. *Id.* Recovery under non-CAS covered contracts requires a special contract clause. *Id.* (citing *ITT Fed. Support Serv., Inc. v. U.S.*, 209 Ct. Cl. 157, 531 F.2d 522 (1976)).

The Impact on Employee Contributions: The Government has asserted that it is entitled to recover surplus attributable to employee contributions. The court held that “nothing in CAS 413.50(c)(12) suggests that the Government is entitled to recover the amounts attributable to the pension contributions of employees.” *Id.* The vehicle for Government recovery is through the Allowable Cost and Payment Clause and the Credits Clause of the FAR and applies only to costs that the Government has reimbursed. Because the Government does not reimburse employee contributions, it is not entitled to the surplus attributable to them. But see Memorandum for Regional Directors, DCAA from R. DiMucci (July 23, 2004), available at <http://www.dcaa.mil>. (Guidance).

The Period of Adjustment: Another issue resolved in the past decade was the cost accounting period to which the “adjustment of previously-determined pension costs” applies. The ASBCA held that the adjustment would be reflected in the contractor’s books and records in the period of the segment closure. *Gould*, supra. *Teledyne* argued that the adjustment must be traced to each prior contract from which the pension surplus or deficit emanated. The Court of Federal Claims held, consistent with the ASBCA, that the adjustment is to occur in the period of the segment closure. *Teledyne* at 181.

The CAS 413 rewrite specifically requires the adjustment in the period when the event triggering the segment closure accounting occurred. CAS 413.50(c)(12)(vii). The CAS rewrite, however, provides for amortization of the adjustment, to the extent that a contractor continues performance of Government contracts.

The Contractor’s Recovery of a Plan Deficit: In most instances, the Government has asserted a non-compliance with CAS 413 due to its alleged entitlement to a pension surplus. *Gould*, supra; *Teledyne*, supra; *Johnson Controls*, supra. The question, however, is whether a contractor is entitled to recover an asset deficit under CAS 413. General Motors sought to recover a pension deficit under the original CAS. The Government agreed to a deficit adjustment, but only to the extent that it applied to flexibly priced contracts. Given the Court of Federal Claims’ decision in *Teledyne*, to which General Motors was an amicus, that there is no adjustment to fixed-price contracts, General Motors would not recover a deficit under fixed-price contracts.

In *Viacom*, the contractor seeks to recover pension asset deficits arising due to the closure of two different segments in 1996. Thus, the CAS 413 rewrite governs. One segment closure involved the sale of the segment, and the other involved the completion of a contract for a segment that only performed that contract. The DCAA acknowledged that the sale constitutes a segment closure; however, the parties dispute the amount of the deficit that Viacom may recover. In neither instance, however, did the Contracting Officer issue a final decision on Viacom’s claims for the pension deficits.

DCAA Audit Guidance: On July 23, 2004, the DCAA issued Audit Guidance in light of the court’s decision in *Teledyne*. See Guidance, supra. The Guidance generally follows the holdings of the decision. The Guidance provides that surplus or deficit attributable to contracts predating CAS 413 will not be included in the adjustment calculation, and that employee contributions up to the date of the applicability of the CAS 413 rewrite would not be included in the calculation. The Guidance provides, however, that employee contributions made after the CAS 413 rewrite would be included in the adjustment calculation for segment closures, or other triggering event, to which the rewrite applies. The Guidance draws this conclusion because the “formula for calculating the Government’s share of the segment adjustment ... does not adjust for employee contributions.” Guidance at 3.

Regarding employee contributions after the CAS 413 rewrite, the Guidance stretches the language of CAS 413. Technically, the formula at CAS 413.50(c)(12)(vi) is silent on the treatment of employee contributions. Thus, the court’s conclusion in *Teledyne* that “[n]othing in CAS 413.50(c)(12) suggests that the government is entitled to recover the amounts attributable to pension contributions made by employees” may be equally applicable to the CAS 413 rewrite. *Teledyne* at 184.

The Guidance also acknowledges the court’s decision that the adjustment under the original CAS 413 does not affect fixed-price contracts. The Guidance concludes that, even where the event triggering the segment closure accounting occurs after applicability of the CAS 413 rewrite, fixed-price contracts subject to the original CAS 413 would not be included in any adjustment of the Government’s share. Guidance at 5.

To determine the “representative period” for adjustment of the Government’s share under the formula, the Guidance provides that data from all years when pension costs were assigned would be considered for pension deficits. When there is a surplus, the adjustment for the Government’s share must exclude pension assets attributable to employee contributions made before applicability of the CAS 413 rewrite.

Finally, the Guidance imposes cost allowability restrictions from FAR 31.205-6(j) on the recovery of a deficit. According to the Guidance, contractor recovery of a deficit is contingent on funding by the federal income tax deadline. The Guidance also counsels that Limitation of Cost and Limitation of Funds clauses in a contract might further restrict contractor recovery. None of these conclusions, however, are based on the case law.

The Future Under CAS 412 and 413—Many of the pressing issues involving recovery under segment closures have been resolved, as discussed above. But as the economic tide has turned, so too will the types of cases disputed under CAS 413. If *Viacom* is an indicator, there will be more contractor cases involving recovery of pension deficits. Those cases will likely test the guidance that calls for consideration of funding issues on the recovery of pension deficits as set out in the cost principles or under the Limitation of Funds clause.

Moreover, it is likely that the Government will seek to insert special contract provisions involving the treatment of pension costs in order to address any perceived loopholes in CAS 413 segment closure accounting and cost/price adjustments. See, *Johnson Controls World Serv., Inc.*, supra (special contract clause included in 1978 contract after promulgation of original CAS 413); *ITT*, supra (special contract provision giving Government ownership of surplus pension assets). Contractors may be equally motivated to enter into advance agreements for treatment of pension costs. See, e.g., *General Elec. Co. v. U.S.*, 60 Fed. Cl. 782 (2004) (court rejected contractor allegation that an advance agreement satisfied all of the contractor’s CAS 413 obligations).

There has been significant focus on CAS 413 segment closures due to the substantial amounts of money involved. CAS 412 and 413, however, involve much more. For example, in *Gould*, the Government questioned each of the actuarial assumptions that

the contractor used to determine pension cost. Under original CAS 412.40(b)(2), the validity of actuarial assumptions was to be determined in the aggregate. Under the CAS 412 rewrite, the validity of actuarial assumptions is to be determined individually. CAS 412.40(b)(2). Thus, the Government might question the contractor’s selected assumptions and assert a noncompliance if the Government disagrees with those assumptions. Changes in assumptions might also be subject to scrutiny.

The Government might also question the contractor’s choice of an actuarial valuation method for the determination of pension costs. See *E-Systems, Inc.*, ASBCA No. 45771, 00-2 BCA ¶ 30982 (Government allegation that a change in actuarial valuation method constituted a change in accounting practice). Another aspect of CAS 412 that has been the subject of controversy includes the requirement for a liability as a prerequisite to allocation of pension costs under CAS 412.40(c). *Eastman Kodak Co.*, ASBCA No. 51326, 01-2 BCA ¶ 31533.

Clearly, every aspect of CAS 412 and 413 is a potential candidate for allegations of noncompliance, and the depth of those CAS is beyond a detailed analysis in this FEATURE COMMENT. It is certain, however, that the subject of pension cost accounting is firmly on the Government’s radar, and the smallest details of pension accounting will be the subject of noncompliance allegations.

Conclusion—The past decade has experienced a significant amount of litigation and other developments in the area of pension cost accounting. The CAS 412 and 413 rewrite has resolved a number of issues that remained for the court and boards to resolve under the original CAS 412 and 413. Because the subject of pension costs and assets is so firmly tied to economics, and now that both the Government and contractors have become sensitized to the numerous issues in both CAS 412 and 413, there will likely be a steady stream of disputes to come.



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