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# Part II

# Office of Management and Budget

## Office of Federal Procurement Policy

## 48 CFR Part 9904

## Cost Accounting Standards Board; Accounting for the Costs of Post-Retirement Benefit Plans Sponsored by Government Contractors; Proposed Rule

## OFFICE OF MANAGEMENT AND BUDGET

### Office of Federal Procurement Policy

### 48 CFR Part 9904

## Cost Accounting Standards Board; Accounting for the Costs of Post-Retirement Benefit Plans Sponsored by Government Contractors

**AGENCY:** Cost Accounting Standards Board, Office of Federal Procurement Policy, OMB.

**ACTION:** Advance notice of proposed rulemaking.

**SUMMARY:** The Office of Federal Procurement Policy, Cost Accounting Standards Board (CASB), invites public comments on a proposed Cost Accounting Standard (CAS) on the costs of post-retirement benefit plans to be recognized as contract cost under Government cost-based contracts and subcontracts. This is a new Standard that would directly address the costs of post-retirement benefit plans for the first time in detail. The proposed Standard provides criteria for measuring the costs of post-retirement benefit plans, assigning the measured costs to cost accounting periods, and allocating the assigned costs to segments of an organization. The allocation of a segment's assigned post-retirement benefit costs to contracts and subcontracts is addressed in other existing Standards. The proposed Standard also provides for the adjustment of post-retirement benefit costs for the effect of a curtailment of a post-retirement benefit plan, a settlement of a post-retirement benefit obligation, a granting of termination benefits, a termination of a post-retirement benefit plan, or a segment closing.

**DATES:** Comments must be in writing and must be received by December 19, 2000.

**ADDRESSES:** Comments regarding this Advance Notice of Proposed Rulemaking should be addressed to Mr. Eric Shipley, Project Director, Cost Accounting Standards Board, Office of Federal Procurement Policy, 725 17th Street, NW, Room 9013, Washington, DC 20503, Attn: CASB Docket No. 96–02A. Please include an electronic copy of your comments in a format readable by MS Word.

**FOR FURTHER INFORMATION CONTACT:** Eric Shipley, Project Director, (telephone: 410–786–6381 or e-mail: EShipley@hcfa.gov) 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)(1), 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 (*e.g.,* promulgation of a Staff Discussion Paper.)
2. Promulgate an Advance Notice of Proposed Rulemaking (ANPRM).
3. Promulgate a Notice of Proposed Rulemaking (NPRM).
4. Promulgate a Final Rule.

This ANPRM is issued by the Board in accordance with the requirements of 41 U.S.C. 422(g)(1)(B) and (C) and is step two of the four-step process.

### B. Background and Summary

*Prior Promulgations*

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 the Financial Accounting Standards Board (FASB) decided to examine the potential liabilities and costs of these plans and ultimately issued Statement No. 106, ''Employers' Accounting for Post-Retirement Benefits Other Than Pensions,'' (SFAS 106) in December of 1990. The adoption of SFAS 106 had the effect of exposing the substantial unfunded liabilities associated with post-retirement benefit plans.

The Cost Accounting Standards Board has received numerous public comments recommending that it establish a case concerning the measurement, assignment, and allocation of the costs of post-retirement benefit plans. These letters came from Federal Government agencies, Government contractors, law firms, trade associations and other respondents. The Board recognized the need to establish a case addressing contract cost accounting issues related to post-retirement benefit plans, but because of the similarities between post-retirement benefit plans 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 (60 FR 16534). At its February 24, 1995 meeting, the CAS Board directed the staff to begin work on a Staff Discussion Paper addressing the accounting treatment of costs of post-retirement benefit plans.

As part of the development of the Staff Discussion Paper, the staff 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. The staff asked for assistance in identifying existing guidance and operational practices that should be investigated. These comments provided important information and ideas that were incorporated into the Staff Discussion Paper.

The Board made available on September 20, 1996, (61 FR 49533), a Staff Discussion Paper, Post-Retirement Benefit Plans Other Than Pension Plans Sponsored by Government Contractors, identifying the cost accounting issues related to post-retirement benefit plans. The Staff Discussion Paper identified major topics for consideration by the Board in its deliberations concerning the possible promulgation of an Interpretation, an amendment to existing Standards, or a new Standard regarding post-retirement benefit costs. The Staff Discussion Paper neither advocated nor assumed any position regarding the accounting treatment of post-retirement benefit costs. Rather, the Staff Discussion Paper explored many different approaches in depth so that the Board would have an opportunity to fully consider alternative treatments for costs of post-retirement benefit plans.

As the Board and its staff analyzed the comments and other information submitted for consideration, it became apparent that many commenters had strongly held opposing positions regarding the firmness of the SFAS 106 liability and the role, if any, that funding should play. To better understand these opposing positions, and hopefully to be able to reconcile these positions, on January 12, 1999 the Board sent a letter to all the respondents to the Staff Discussion Paper. This letter was also made widely available for public comment on February 18, 1999 (64 FR 8141).

*Public Comments*

The Board received eighteen (18) sets of public comments in response to the Staff Discussion Paper. These comments came from contractors, Government agencies, professional associations, actuarial firms, and individuals. These public comments are briefly summarized as follows:

Most respondents did not favor the promulgation of a new Standard and believed that the Board could adequately address post-retirement benefit costs through amendments to CAS 9904.412 and 9904.413. A few respondents expressed the belief that the measurement, assignment, and allocation of post-retirement benefit costs were complex and technical subjects and recommended that the Board address post-retirement benefit costs in a comprehensive manner.

The respondents almost universally agreed that accrual accounting following the provisions of SFAS 106 was the most appropriate basis for measuring and assigning the costs of a post-retirement benefit plan that created a firm liability. They stated that the pay-as-you-go cost method (cash basis accounting) was appropriate if there was not a firm; *i.e.,* compellable, liability to provide the promised benefits. However, there was no general agreement as to the criteria for ascertaining the firmness of a plan's liability; especially as to whether funding of the cost should serve as a criterion. There was agreement that if funding was to be a prerequisite for accrual accounting, then any rule or amendments should provide sufficient flexibility in the choice of accounting methods to permit contractors to align their cost accounting practice with their funding opportunities.

Respondents recommended that the Board address special events such as a curtailment of benefits or the termination of the post-retirement benefit plan. Many commenters suggested that a funding requirement may not be necessary if the Board provided adequate safeguards in case of a plan termination or segment closing. Some respondents asked that the segment closing provisions for post-retirement benefit costs be explicitly coordinated with the segment closing provisions of paragraph 9904.413–50(c)(12) regarding pensions.

The Board also received ten (10) sets of comments in response to the Board's letter of January 12, 1999 which can be summarized as follows:

The comments from contractors and other industry representatives reiterated their belief that funding was not necessary to substantiate the liability. Several of these respondents opined that funding did not improve the firmness of the liability. Instead, these respondents expressed the belief that the terms of the post-retirement benefit plan determined the firmness of the liability.

Most commenters, including the Office of the Under Secretary of Defense (OUSD), argued that funding was an allowability; *i.e.,* procurement policy issue, and not an accounting issue. The other two Government respondents expressed a strong belief that funding demonstrated the contractor's intent to continue the post-retirement benefit plan and to be financially prepared to provide the promised benefits.

The Board also reviewed proposed amendments to CAS 9904.412 and 9904.413 addressing post-retirement benefit costs which were voluntarily submitted by the Council of Defense and Space Industry Associations (CODSIA), as well as comments submitted by the American Bar Association's (ABA) Public Contract Law Section regarding CODSIA's proposal.

The Board reviewed information from the Towers Perrin surveys of ''SFAS 87 [Statement 87 of the Financial Accounting Standards Board] and SFAS 106 Annual Report Footnote Data'' for years 1995, 1996, 1997, and 1998 which was extracted from the corporate financial statements of the ''Fortune Top 100'' companies. The Board notes three (3) major observations that one can generally conclude from this survey information that influenced the development of this proposed Standard.

1. For pensions, the plan assets generally equaled or exceeded the liability for projected benefits, as measured by the SFAS 87 projected benefit obligation. On the other hand, only slightly over one-half (½) [1] of the companies included in the survey reported any plan assets for their post-retirement benefits plans. For companies that did report plan assets, for 1998 the average plan assets only covered around one-third (⅓) of the average SFAS 106 accumulated post-retirement benefit obligation.

2. While the average SFAS 106 accumulated post-retirement benefit obligation for these Fortune 100 companies is less than one-third [2] of the average SFAS 87 projected benefit obligation for pensions, at $2,312.5 million for 1998, the average post-retirement benefit obligation is still quite large.

3. The 1998 average net periodic cost for post-retirement benefit plans ($150.7 million) exceeds the average net periodic cost for pension plans ($58.4 million).

This proposed Standard is based upon the continuing research performed by the staff of the Cost Accounting Standards Board and the public comments received in response to the Staff Discussion Paper and the Board's January 12, 1999 letter.

The various comments and proposals are discussed in greater detail under Section E, Public Comments. The Board and its staff would like to thank all the organizations and individuals who provided comments and information in response to the Staff Discussion Paper and the Board's January 12, 1999 letter.

*Conclusions*

While accounting for post-retirement benefits has some similarities with pension accounting, the Board has concluded that post-retirement benefit costs should be treated distinctly from pension costs. The Board proposes to address the accounting treatment of post-retirement benefit costs through the promulgation of a new Cost Accounting Standard rather than through an Interpretation of or an amendment to an existing Standard or Standards. Post-retirement benefits, pensions, and insurance are each intrinsically complex and technical subjects. The Board has determined that it would be extremely difficult, if not impossible, to effectively and efficiently interleave coverage for post-retirement benefit costs into either the pension or insurance Standards.

The Board believes that accrual accounting is the appropriate method for determining the costs of post-retirement benefit plans that create a sufficiently firm liability for contract cost recognition. The Board has concluded that SFAS 106 with some modifications and restrictions provides adequate and appropriate accounting guidance regarding the measurement and period assignment of post-retirement benefit costs when accrual accounting is utilized. In order to implement a definite determination of a firm liability, the Board decided that the annual accrual of the post-retirement benefit cost must be compared to the nonforfeitable portion of the accumulated post-retirement benefit obligation. Post-retirement benefit plans that do not create a firm liability for contract costing purposes must be accounted for using the pay-as-you-go cost method.

The Board has also determined that specific guidance is required regarding the allocation of post-retirement benefit cost to segments. Specifically, the Board believes criteria are necessary regarding when the post-retirement benefit costs of a segment should be based on a general allocation or a separate calculation. Furthermore, because the current and future costs of post-retirement benefit plans are dependent upon the costs accrued in prior periods and the funding of such prior accruals, the Board finds it necessary to provide for the accounting treatment for assets

[1] 82 companies reported pension plan assets in their SFAS 87 footnotes and 45 companies reported post-retirement benefit plan assets in their SFAS 106 footnotes.

[2] The average Projected Benefit Obligation reported in the SFAS 87 footnotes was $7,170.6 million.

and for the accumulation and reporting of unfunded accruals at the segment level.

The Board has concluded that the SFAS 106 provisions on benefit curtailments, liability settlements, and the granting of special termination benefits are inadequate for contract costing purposes and additional guidance is needed. The Board further concluded that specific guidance is needed to address the appropriate contract cost accounting when a segment, as defined by paragraph 9904.403–30(a)(4), is abandoned, sold, or otherwise closed.

*Benefits*

The Board's proposal will eliminate the existing confusion as to which Standard, if any, addresses the contract cost accounting for post-retirement benefits. There have been various opinions and theories as to the proper basis for contract cost accounting for post-retirement benefit plans. Various parties have advocated using either the pension Standards, CAS 9904.412 and 9904.413, or the insurance Standard, Cost Accounting Standard 9904.416. Others have expressed a belief that no existing Cost Accounting Standard addresses such costs. Many parties have argued that Generally Accepted Accounting Principles (GAAP) as evidenced by SFAS 106 should govern the accounting of post-retirement benefit costs, and in fact, paragraph 31.205–6(o) of the Federal Acquisition Regulation (FAR 31.205–6(o)) specifies SFAS 106 as the basis for accrual accounting. A few have even suggested that the tax accounting rules for Internal Revenue Code (IRC) section 501(c) (26 U.S.C. 501(c)) trusts might be an appropriate basis. The Board proposes to clarify the accounting treatment of post-retirement benefit costs for Government contract costing purposes by specifying SFAS 106 as the basis for measurement and period assignment when the proposed criteria for accrual accounting are satisfied.

The Board acknowledges that the accounting for post-retirement benefit costs is a complex subject. When accrual accounting is used, the reliance on the methods and techniques of SFAS 106 for measurement and period assignment eases the burden of complying with this proposed Standard because contractors will be able to use much of the same data and methods used for financial accounting purposes. If use of the pay-as-you-go cost method is required, the determination of costs will be based on actual payments of benefits. Therefore, there should be minimal additional cost associated with complying with the Standard for the plan as a whole, although certain additional effort may be necessary to comply with the proposed provisions regarding the accounting for costs of segments. Furthermore, the proposed criteria regarding when to use accrual accounting or the pay-as-you-go cost method will eliminate disputes and will increase uniformity among contractors.

In the Board's judgement, a Standard is needed to increase consistency of results between accounting periods. Various provisions of SFAS 106 permit contractors to select between full immediate recognition, amortization, and in the case of annual gains and losses, delayed recognition of the various components of post-retirement benefit cost. The Standard being proposed today generally limits the contractor's cost recognition to the amortization method. Besides enhancing uniformity between accounting periods, dampening volatility through amortization will increase predictability when cost data is used to price contracts covering future periods.

The provisions of SFAS 106 and GAAP generally do not address the allocation of costs to segments of the contractor. The additional guidance being proposed addresses this point. While SFAS 106 addresses how major changes in the post-retirement benefit plan; i.e., benefit curtailments, liability settlements, and granting special termination benefits, are to be reported within the results of operations for financial reporting purpose, SFAS 106 does not address how such results are allocated to cost objectives. This proposal provides guidance on how the costs resulting from such major changes in post-retirement benefit plans are to be allocated and recognized for Government contract costing purposes. This proposed Standard also provides for a final settlement based on the proposed measure of the firm liability when the contracting relationship between the Government and a segment ends; this is not addressed by SFAS 106.

The proposed Standard also delineates how post-retirement benefit assets and liabilities are to be accounted for when a segment is divided or combined with another segment as part of an internal reorganization, corporate merger, or when part of the segment is sold or ownership is transferred. This delineation will enable the parties to the sale or transfer to better determine the value of the segment's post-retirement benefit plan assets and liabilities maintained for Government contracting purposes.

In summary, the Board believes that the consistency with financial accounting, specificity as to which benefits are recognized on an accrual or cash accounting basis, and the guidance on allocation of cost to segments will enhance the cost proposal, price negotiation, contract administration and audit processes. The benefits of such enhancements should be substantial and should greatly outweigh any added costs.

*Summary Description of Proposed Standard*

The proposed Standard is divided into six subsections which address (a) the recognition and identification of post-retirement benefit costs, (b) the measurement and period assignment of post-retirement benefit costs, (c) the allocation of post-retirement benefit costs to segments, (d) the allocation of post-retirement benefit costs from segments to the intermediate and final cost objectives of a segment, (e) the adjustment of the contractor's records when there is a curtailment, settlement, or granting of special termination benefits, and (f) the adjustment of contract pricing when a segment is closed. Once it is determined under subsection (a) whether the cost of a particular post-retirement benefit plan is to be accounted for using accrual accounting or the pay-as-you-go cost method, the other sections present the relevant provisions in the following order of applicability: all plans, plans using the pay-as-you-go cost method, defined-contribution plans using accrual accounting, and finally, defined-benefit plans using accrual accounting. In this way, readability and the ability to reference is enhanced. For example, contractors using the more straightforward pay-as-you-go cost method do not need to search the entire subsection for applicable guidance.

1. Definitions

Proposed subsection 9904.419–30(a) includes several new definitions of terms that are unique to post-retirement benefit plans. These new definitions include modified SFAS 106 definitions and selected unmodified SFAS 106 definitions that are frequently used in the proposed Standard. Terms that are applicable to post-retirement benefits plans, but which have previously been defined for pensions, have been modified (usually substituting ''post-retirement benefit'' for ''pension'') in subsection 9904.419–30(b) for purposes of this proposed rule. Subsection (c) incorporates all other SFAS 106 definitions into the proposed Standard.

2. Recognition of Post-Retirement Benefit Costs

(a) *Criteria for accrual accounting.* For SFAS 106 purposes, the post-retirement benefit promise arises from the written documents or established practices that comprise the ''substantive plan.'' Subsection 9904.419–40(a) sets forth criteria for determining when the liability for the post-retirement benefit is sufficiently estimable, contractually obligated (compellable), and reasonably foreseeable to warrant accrual accounting for government contract accounting purposes. The proposed criteria require that the promise of future benefits be: (i) Documented in writing, (ii) communicated to employees, (iii) nonforfeitable once earned, and (iv) legally enforceable.

The proposed Standard's requirement that the benefit promise be formalized in writing is consistent with similar CAS provisions regarding pension, insurance, and deferred compensation costs. The pension and insurance Standards require that costs of employee benefits contingent on post-retirement events, such as mortality and inflation, be actuarially determined and funded. This proposed Standard, like Cost Accounting Standard 9904.415, which addresses the accounting for costs of deferred compensation, does not require funding but instead requires that the contractor have a duty to pay the benefit earned by the employee which the contractor cannot unilaterally avoid. As with the pension and insurance Standards, if the post-retirement benefit plan fails to meet the specified criteria for accrual accounting, then the contractor must use the pay-as-you-go cost method.

(b) *Identification of the post-retirement benefit plan.* Some companies that have chosen to fund all or a portion of their post-retirement liability use a combination of investment vehicles to achieve tax-efficient funding of post-retirement benefits. Companies sometimes find they must sponsor somewhat different retiree insurance plans for different plants, states, or classes of employees in order to provide an overall general post-retirement benefit promise. Thus, their post-retirement benefit program is frequently not a single benefit plan, but several different benefit promises to different groups of employees.

To accommodate such pragmatic concerns associated with sponsoring and administering a post-retirement benefit program, the proposal being published today permits contractors to combine different investment vehicles and trust arrangements when identifying the assets of a post-retirement benefit plan. Similarly, the proposed Standard also provides that different benefits provided to the same group of employees, or the same benefit provided to different groups of employees may be aggregated for Government contract accounting purposes. Conversely, different benefits within a single overall plan may be accounted for separately.

Consistent with the position taken by the FASB, the proposed paragraph 9904.419–50(a)(7) explicitly covers separate accounts for medical benefits that are a part of a qualified pension plan and trust (IRC section 401(h) accounts) in this proposed Standard on post-retirement benefits. These medical benefit accounts, which are established, accounted for, and funded distinctly from the retirement income benefit of a qualified pension plan, are not an ''integral part of a pension plan.''

3. Measurement and Assignment of Post-Retirement Benefit Costs

(a) *Pay-as-you-go cost method.* The proposed Standard provides that for plans using the pay-as-you-go cost method, the assignable cost is measured by an amount equal to the payments made to or on behalf of the plan beneficiaries, providers, and insurers for benefits incurred during the current period, except that any amount paid to settle or terminally fund a liability for current and future benefits must be amortized over fifteen (15) years. Because the fifteen-year period represents an approximation to the life expectancy of a newly retired employee, this provision is consistent with paragraph 52 of SFAS 106 which requires the cost to be spread over the life expectancy of the retirees if the obligation is primarily attributable to such retirees. The proposed Standard is also consistent with the analogous provisions for pensions and insurance which are found at 9904.412–40(b)(3)(ii) and 9904.416–50(a)(1)(v)(C), respectively. The proposed transition provisions permit the continued use of the terminal funding method (without amortization) for contractors who have an established practice of terminal funding prior to this proposed Standard becoming applicable.

When describing the post-retirement benefit payments considered under the pay-as-you-go cost method, the proposed Standard augments the CAS 9904.412 definition of the ''pay-as-you-go cost method'' by adding the phrase ''or on behalf of'' because post-retirement benefit payments are often made directly to third parties, *e.g.,* health care providers. The proposed Standard also refers to the ''net amount'' of the benefit paid to indicate that the cost is based on the contractor's share of the post-retirement benefit after considering refunds, co-payments, deductibles, and amounts payable by unrelated third parties, such as Medicare and Medicaid. This use of ''net amount'' is consistent with the SFAS 106 provisions relating to ''incurred claim cost (by age)'' and ''net incurred claim cost (by age).'' This concept is also consistent with subparagraphs 9904.416–50(a)(1)(i) and (a)(1)(vi) of the insurance Standard, CAS 9904.416.

(b) *Accrual accounting for defined-contribution plans.* For defined-contribution plans using accrual accounting, the proposed Standard follows paragraph 104 of SFAS 106 and measures the assignable cost as the annual amount paid to or otherwise distributed to individual participant accounts. However, in contrast to paragraph 105 of SFAS 106, the proposed Standard does not permit the pre-retirement accrual of contributions expected to be made after retirement. Rather, contributions made after retirement are recognized in the period when the contribution is required under the terms of the plan. This proposed provision, paragraph 9904.419–40(b)(3), is generally consistent with paragraph 9904.412–40(a)(2) of the pension Standard.

(c) *Accrual accounting for defined-benefit plans.* For post-retirement benefit plans that meet the proposed prerequisites for accrual accounting, the Standard being proposed today accepts the actuarial cost method and actuarial assumptions used by the contractor for financial accounting purposes under SFAS 106. The assignable cost is based on the same six (6) components used by SFAS 106, namely: service cost, interest cost, actual return on assets, amortization of prior service costs, amortization of gains and losses, and recognition of the transition obligation.[3] However, the Board proposes to modify or restrict the SFAS 106 measurement and assignment of some components as explained below. Therefore, the values of these components used for contract costing purposes may differ from the values used for financial accounting purposes. Because the proposed measurement and assignment methods and techniques follow SFAS 106 rather than CAS 9904.412, there is no floor placed on the measurement and assignment of the period cost; *e.g.,* the

[3] Throughout this preamble, the term ''transition obligation'' is used to refer to either a transition obligation or a transition asset.

assignable post-retirement benefit cost could be a negative amount.

Because contractors may wish to maintain the right to curtail or terminate the benefits for employees who have not yet reached full eligibility, the Board has decided that it would be inappropriate for Government contract costing purposes for the accumulated value of accruals, whether funded or unfunded, to exceed the unavoidable liability for post-retirement benefits. The proposed rules include a ceiling on the accrual cost recognition equal to the benefits paid during the period plus the unfunded portion of the accumulated post-retirement benefit obligation for benefits that cannot be forfeited.[4] The Board notes that the greater the portion of forfeitable benefits included in the accumulated post-retirement benefit obligation, the more restrictive will be the effect of the ceiling.

(i) Service cost, amortization of prior service costs, and interest components. The Board proposes to accept the SFAS 106 provisions regarding the measurement and assignment of the service cost and the amortization of prior service cost components of post-retirement benefit cost but restricts that measurement to the written terms of the post-retirement benefit plan rather than the ''substantive plan.'' Otherwise, there are no modifications or restrictions to the SFAS 106 measurement and assignment provisions for these three components of post-retirement benefit cost.

(ii) Return on assets component and associated asset values. The Board proposes to accept the same measurement of the fair value of assets and the market-related value of assets used for financial accounting. The terminology of the proposed Standard follows that of SFAS 106 and differs from that used for pensions in CAS 9904.412 and 9904.413. The CAS 9904.412 term ''market value of plan assets'' is analogous to the term ''fair value of plan assets'' as used in SFAS 106 and this proposed Standard. The term ''actuarial value of assets'' used in the Employees' Retirement Income Security Act of 1974 (ERISA) and CAS 9904.412 is defined similarly to the ''market-related value of plan assets'' as used by SFAS 106 and this proposed Standard. For pensions the actuarial value of assets not only affects the recognition of gains and losses, but also is used to determine the unfunded actuarial liability. However, the market-related value of plan assets is only used to measure the annual asset gain or loss under SFAS 106 and this proposal. In SFAS 106 and in this proposed Standard, the fair value of assets is used to determine the unfunded accumulated post-retirement benefit obligation.

SFAS 106 is not concerned with the sources of any net accumulated accrued (unfunded) or prepaid post-retirement benefit cost. By contrast, the Board proposes that the contractor record and track each portion of unfunded accrual and prepayment credit. Consistent with CAS 9904.412, the accumulated values of unfunded accruals and prepayment credits are carried forward and adjusted for interest. The accumulated value of unfunded accruals is treated as if it were a plan asset and the accumulated value of prepayment credits is treated as a reduction to assets. The proposed Standard requires that the actual return on assets component be increased by an interest equivalent on the accumulated value of unfunded accruals to reflect that assets would have generated earnings had the full accrual amount been funded. Similarly, the actual return on assets component is reduced by an interest equivalent on the accumulated value of prepayment credits to reflect the additional earnings generated by any funding in excess of the annual accrual.

The Board has decided that the interest rate determined by the Secretary of the Treasury pursuant to Public Law 92–41, 85 Stat. 97, shall be used to measure the interest equivalent on the accumulated values of unfunded accruals and prepayment credits. The Board notes that for unfunded plans, there are no assets (no investments) and the contractor does not need to make an assumption concerning the long-term expected rate of return. In other cases, the amount of plan assets may be so small that reliance on this assumption may be inappropriate for Government contracting purposes. Also, use of the Treasury rate is consistent with the other Standards.

(iii) Annual gain or loss component. In order to more closely assign costs to cost accounting periods in which they arise, the proposed Standard requires the amortization over the average remaining service period of active participants[5] of the full amount of the annual gain or loss for a cost accounting period, that is, gains and losses other than gains and losses attributable to curtailments, settlements, or special termination benefits. While SFAS 106 permits such amortization, SFAS 106 only requires amortization of that part of the cumulative net gain or loss that falls outside a corridor defined by 10% of the greater of the accumulated post-retirement benefit obligation or the market-related value of plan assets. Under SFAS 106, recognition of any gain or loss within that corridor may be delayed indefinitely. Such delayed recognition is not permitted by this proposed Standard.

(iv) Amortization of the transition obligation component. This proposed Standard restricts the measurement and period assignment of the transition obligation to the delayed recognition method described in paragraphs 112 and 113 of SFAS 106. The proposed Standard provides that when a contractor first becomes subject to the proposed Standard, the contractor will base its period costs on the annual amortization installment for the unrecognized portion of the transition obligation already established for financial accounting purposes. The proposed transition provisions address the recognition of any portion of the SFAS 106 transition obligation that was recognized for financial statement purposes during prior periods for those contractors that used the pay-as-you-go cost method for Government contract costing purposes.

(d) *Post-retirement benefits provided through insurance contracts.* If the contractor provides all or a portion of the post-retirement benefit by purchasing insurance, the Board proposes that the contract accounting cost be determined by the net premium paid for such insurance and that the measurement, assignment to cost accounting periods, and allocation of such premium be subject to the provisions of CAS 416. However, if the insurance is acquired from a captive insurer, then the cost of the post-retirement benefit remains subject to the provisions of this proposed Standard. Because the SFAS 106 definition of ''captive insurer'' differs from the term as used in the FAR, a potential for disputes exists. In addition, the proposed definition clarifies that affiliates, related organizations and entities that are ''owned by or under the control of'' the contractor are also included so that the proposed Standard incorporates the phrase found at FAR 31.201–19(c) which is already in use for Government contracting purposes. Consistent with SFAS 106, this proposed Standard permits benefits provided by purchased insurance to be accounted for separately from any portion of a plan's benefits that are not

[4] Hereafter, the accumulated post-retirement benefit obligation for benefits that cannot be forfeited is referred to as the ''nonforfeitable post-retirement benefit obligation.''

[5] If the plan population is composed primarily of retirees, the gain or loss is spread over the life expectancies of the retirees. (See paragraphs 52 and 112 of SFAS 106.)

provided through such insurance. The Board notes that this treatment contrasts with the analogous provision in the pension Standard, paragraph 9904.412–50(a)(6), which specifies the accounting for so-called ''split-funded'' plans.

4. Allocation of Post-Retirement Benefit Costs to Segments

The proposed Standard applies to all post-retirement benefit plans regardless of whether accrual accounting or the pay-as-you-go cost method is used. It embraces the general precepts of paragraph 9904.403–40(b)(4) dealing with the allocation of central payments and accruals to segments. However, this proposed Standard provides specific criteria regarding the allocation of post-retirement benefit costs to intermediate home offices and segments.[6] The contractor must allocate a portion of the total post-retirement plan cost to each segment, including home offices, either by use of an appropriate allocation base (*i.e.,* indirect allocation) or, if certain conditions exist, by use of post-retirement benefit costs separately computed (*i.e.,* direct allocation) at the segment level.

Consistent with the pension and insurance Standards, the Board proposes that the total post-retirement benefit plan cost be allocated to intermediate home offices and segments based upon the factors used to determine the costs. For plans that are accounted for using the pay-as-you-go cost method, the cost is to be allocated only to segments and intermediate home offices that can be identified with the post-retirement benefit plan (*e.g.,* those segments having inactive participants who are eligible to receive benefits under that plan). For defined-benefit plans using accrual accounting, the proposed Standard requires that both active and inactive plan participants of the segment or intermediate home office be included in the allocation base because five of the six components of post-retirement benefit cost are dependent upon the obligation for both groups.[7]

The criteria requiring separate calculation are similar to those found in CAS 9904.413 for pension costs of segments. If actual benefits are disproportionately paid to participants of certain segments, the proposed Standard requires a separate calculation of the cost for the segment instead of an allocation, even for costs determined under the pay-as-you-go cost method. An additional criterion for separate calculation that looks at the ''cost of benefits'' reflects the fact that post-retirement benefit costs may vary significantly due to differences in state laws, geographical location, or insurance market.

Unless the post-retirement benefit cost allocable to a segment is separately calculated, the same set of actuarial assumptions is used to determine the cost for all segments. Similar to CAS 9904.413, if costs are separately calculated, only those assumptions relating to the demographic differences of a segment's employees are permitted to be different than the assumptions used for other segments. For example, the use of a different turnover assumption to reflect the unique termination of employment experience of one segment does not permit the contractor to use a different pre-retirement mortality assumption without evidence that the segment's mortality is materially different from the average mortality assumed for the plan as a whole.

For defined-benefit plans using accrual accounting the proposed Standard requires that the tracking of assets and funding at the segment level be maintained if costs are separately calculated for the segment. This provision increases the visibility and verifiability of post-retirement benefit costs that are separately calculated for a segment.

This proposed Standard also requires that the market-related value of plan assets be allocated each year in proportion to the fair vale of plan assets allocated to the segments. This provision ensures that the sum of the market-related value of plan assets for all segments equals the total plan's market-related value of assets.

The proposed provisions regarding transfers of plan participants between segments reflect the fact that the accumulated post-retirement benefit obligation is determined by and must follow the plan participants. Therefore, both the assets that funded the obligation and the unfunded portion of the accumulated post-retirement benefit obligation follow the participants, so that future contract costs better follow the performance of future contracts. The Board notes that the exception for immaterial transfers might create a small gain or loss because assets and other values are not transferred.

5. Allocation to Intermediate and Final Cost Objectives of the Segment

Once the post-retirement benefit cost has been measured, assigned to a period, and initially allocated to segments and home offices, the Board believes that Cost Accounting Standard 9904.403 adequately addresses the reallocation from home offices to segments and that Cost Accounting Standard 9904.410 and Cost Accounting Standard 9904.418 fully and adequately address the intra-segment allocation of cost to intermediate and final cost objectives.

6. Adjustments for Curtailments, Settlements, and Special Termination Benefits

(a) *Defined-contribution plans using accrual accounting.* While a defined-contribution plan is on-going, any nonvested account balances that are forfeited by participants who terminate employment during a cost accounting period are typically either reallocated to the other participants or used to reduce the contribution (deposit) required under the terms of the plan. The Board presumes that such forfeiture credits are fairly evenly distributed among periods and therefore no undue volatility occurs. However, when a defined-contribution plan is terminated, the forfeiture of nonvested account balances could cause an inordinately large and non-recurrent credit. In fact, the values of the non-vested account balances could revert to the contractor. To prevent the disruption to the budgeting process for cost type contracts and the forward pricing process for cost-based fixed price contracts, the Board proposes that forfeiture credits due to a termination of a defined-contribution plan using accrual accounting be amortized over 10 years so that the credit can flow to costs included in both cost type contracts and the forward pricing of other negotiated cost-based contracts.

The Board also proposes that this provision will apply to forfeitures that occur whenever the plan participants' rights to become vested are eliminated because the right to earn future vesting or retirement eligibility service is curtailed or terminated by plan amendment or other unilateral action of the contractor.

The pension Standards do not contain a similar provision because qualified pension plans are subject to the vesting requirements of ERISA. However, many post-retirement benefit plans are not subject to similar vesting standards and the Board believes these provisions are necessary to address the significant

[6] Throughout the discussions of allocations to segments and to intermediate and final cost objectives, the term ''segment'' is used to refer to a segment, home office, or intermediate home office.

[7] The service cost component is only determined for active plan participants who are still in the attribution period, *i.e.,* prior to the date of full eligibility. A service cost is not developed for inactive plan participants.

amount of nonvested account balances that might be forfeited.

(b) *Defined-benefit plans using accrual accounting.* Consistent with the Board's intention to accept the accounting provisions of SFAS 106 where practicable, the proposed Standard begins by accepting the SFAS 106 measurement of the adjustment for gains and losses due to benefit curtailments, benefit settlements, and granting of special termination benefits. SFAS 106 provides that any gain or loss not offset against the unrecognized gain or loss, unrecognized transition obligation, or unrecognized prior service cost, as appropriate under SFAS 106, will be immediately recognized in income. To require an analogous immediate recognition for Government contract costing purposes could disrupt the budgeting of cost type contracts as well as the forward-pricing process for cost-based fixed price contracts. Regardless of whether or not the post-retirement plan is terminated, the proposed Standard requires that an adjustment be recorded and that the adjustment for the curtailment, settlement, or termination benefit gain or loss be amortized over a period of 10 years.

7. Adjustments for Segment Closings.

The Board proposes to adopt the CAS 9904.413 definition of segment closing which encompasses three situations: (i) The ownership of the segment changes by sale or transfer, (ii) the segment discontinues operations or is abandoned, and (iii) the contractor is no longer performing or actively seeking government contract work at that segment. Based on comments regarding the amendments to the pension rule, the Board has modified the CAS 9904.413 definition of segment closing to explicitly state that segment mergers or splits within the contractor's on-going operations are not considered to be a segment closing for purposes of this proposed Standard.

(a) *Pay-as-you-go cost method.* When a segment is closed for any of the reasons described above, this proposed Standard does not provide for any adjustment to current or previously determined post-retirement benefit costs for plans that use the pay-as-you-go cost method. The post-retirement benefit costs attributable to current and prior periods were previously determined by the net amount paid to or on behalf of retired employees or their beneficiaries for post-retirement benefits incurred during those periods. The measurement of these prior actual expenditures is unaltered by the segment closing. These previously determined costs include any amortization installments assigned to such prior periods for net amounts paid to irrevocably settle an obligation for post-retirement benefits.

The proposed segment closing provisions also require that any inactive participants left ''homeless'' (that is, inactive participants that are no longer associated with an operational segment) when a segment is sold or abandoned must be moved to the intermediate or corporate home office to which the closed segment had directly reported. In the future the pay-as-you-go costs for these transferred inactive participants will be included in the post-retirement benefit costs allocated by the closed segment's immediate home office (the proximate home office to which the segment had reported.) Likewise the amortization of lump sums and other settlements for these inactives will continue unabated after being transferred to the closed segment's immediate home office. Any Government contracts performed in other segments reporting to that home office will receive an allocated portion of the post-retirement benefit costs attributable to the transferred inactive participants.

(b) *Defined-contribution plans using accrual accounting.* When a segment is closed for any of the reasons described above, the Board proposes that the contractor measure an immediate period adjustment to recognize any unrecognized portions of any credits for forfeited nonvested account balances due to plan termination or curtailment of vesting or retirement eligibility service. Essentially, this provision aborts the amortization of these credits because there will be no Government contracts in future periods to absorb a share of the credit.

(c) *Defined-benefit plans using accrual accounting.* When a segment is closed for any of the reasons described above, the Board proposes that the contractor measure an immediate period adjustment based upon the unavoidable liability for post-retirement benefits. The adjustment is measured as the difference between the nonforfeitable post-retirement benefit obligation and the sum of the plans assets plus the accumulated value of unfunded accruals (net of any prepayment credits.)

Basing the segment closing adjustment on the nonforfeitable post-retirement benefit obligation may appear to be a fundamental conceptual departure from both the original and amended CAS 9904.412 and 9904.413. The benefit liability for pension plans generally is subject to the stringent controls of ERISA. For post-retirement benefit plans, the nonforfeitable post-retirement benefit obligation provides the nearest analogue to the ERISA protected liability.

In addition to the above proposed general rules for segment closings, the following points should be noted:

(i) Massive layoff gains. The Board notes that when a segment closes, often there is a sizable termination of employees which was one of the original Board's concerns that eventually led to the original 9904.413–50(c)(12) segment closing provision. For post-retirement benefit plans, the effects of any ''abnormal forfeitures'' or massive layoff gain will dramatically reduce the liability such that the remaining accumulated post-retirement benefit obligation will approximate or equal the nonforfeitable post-retirement benefit obligation.

(ii) Sale or other transfer of ownership of a segment. When a segment is sold or transferred, the active participants of the segment immediately before the sale is effective can be: (i) Transferred with the segment and become active employees of the buyer, (ii) transferred as active employees to other operational segments of the seller, or (iii) terminated and become inactive participants of the seller. When analyzing the proposed provision concerning the sale or transfer of a segment, the reader should carefully consider the plan participants' status in the post-retirement benefit plans of each party to the sale. If both parties to the sale sponsor post-retirement benefit plans, the segment's employees can be both inactive participants in the seller's post-retirement benefit plan and active participants in the buyer's plan.

If only a portion of the operations of a segment is acquired, the proposed Standard provides that the selling contractor first divide the accounting records for the segment into two groups based upon the liability for participants being retained and transferred. Then the segment closing adjustment will be determined using the accounting records for the participants being transferred to the buyer or transferee. This proposed Standard also provides that, when a segment is divided into two or more segments as part of a reorganization, the assets shall be divided in proportion to the accumulated post-retirement benefit obligation. This provision is more specific than the similar coverage found at 9904.413–50(c)(v) for pension plans.

If no active employees are retained in the segment, the unrecognized transition obligation, prior service cost, gains and losses attributed to the remaining inactive participants are moved up to the next immediate home office along with the associated fair

value of plan assets, accumulated value of unfunded accruals and accumulated value of prepayment credits. All amortizations continue unabated. This amortization of these unrecognized amounts parallels the treatment of the liability for future payments to remaining inactives under the pay-as-you-go method.

Unless a segment is sold to a successor-in-interest, the adjustment will be determined using the values of assets and accumulated benefit obligations immediately prior to the sale. If the segment is sold to a successor-in-interest, this proposed Standard provides that the segment accounting will continue at the successor contractor based on the segment accounting up to the time of the sale, taking into account any division of the segment's assets and obligations.

(iii) Government's share of segment closing adjustment. The Government's share of the segment closing adjustment shall reflect the Government's historical participation in post-retirement benefit cost from the time this proposed Standard first becomes applicable. The intent of this provision is for the cognizant Federal agency official and the contractor to generally determine the Government's historical share of post-retirement benefit costs that were allocated to cost type and negotiated cost-based fixed price contracts. The proposed transition provisions extend this period of participation for contractors who employed accrual accounting for Government contract costing in accordance with SFAS 106 prior to this proposed Standard becoming applicable. In such cases, the Government's participation shall be measured from the date that SFAS 106 accruals used for financial statement purposes were first used for Government contract costing purposes. The proposed Standard also permits the parties to negotiate a delayed recognition of the segment closing adjustment through an amortization process. This proposed provision provides more flexibility for the parties to determine the appropriate proportion than paragraph 9904.413–50(c)(vii) of the pension Standard.

8. Illustrations

Generally the illustrations show the accumulated post-retirement benefit obligation and other liabilities or losses as debit balances and the fair value of assets and other asset equivalent values and gains as credit balances. However, for consistency with financial accounting presentation, when the illustrations include SFAS 106 disclosures, the accumulated post-retirement benefit obligations are shown as credit balances and fair values of assets and other asset equivalent values are shown as debit balances.

Because health and life benefits account for about 98% of all post-retirement benefit plan obligations, there are no illustrations or special provisions for post-retirement benefits other than health and life benefits. This lack of text or illustrations regarding other types of post-retirement benefits does not imply nor indicate that the obligations for such benefits, if material, are excluded from coverage under this proposed Standard.

9. Transition Provisions

One of the issues raised in discussions about post-retirement benefit costs concerns inactive plan participants who may have worked for a strictly commercial segment or a government segment that was sold or abandoned at some time in the past. It has been argued that the post-retirement benefit costs associated with these so-called ''homeless'' inactives should be explicitly excluded from the post-retirement benefit costs allocated to current and future Government contracts. However, often it is impossible to ascertain whether these ''homeless'' inactives were formerly employed in an abandoned or sold segment or if they are ''homeless'' because of incomplete human resource records. Rather than require a herculean and possibly futile effort to identify where these inactive participants had been employed, the Board proposes that the retained liability for these ''homeless'' inactive participants be assigned to an intermediate home office or corporate office in accordance with the contractor's past practice. The costs associated with these inactive participants will be treated as a general cost of doing business for such home office and allocated in accordance with CAS 9904.403.

Some contractors may not have established a specific practice or method for assigning the ''homeless'' participants to a corporate or intermediate home office. In that case, the Board envisions several acceptable methods of making such an assignment to home offices. These include, but are not limited to:

(i) Assigning all ''homeless'' to the corporate home office if the post-retirement plan covers employees in all units that report to the corporate home office;

(ii) Assigning the ''homeless'' to the immediate home office that had responsibility for the closed or abandoned segment;

(iii) If the closed or abandoned segment(s) were primarily associated with a portion of the contractor's current business, assigning the ''homeless'' to a home office which allocates the post-retirement benefit cost as a residual expense to segments currently performing work for that portion of the contractor's business; or,

(iv) Those ''homeless'' participants for whom employment records are unavailable, or who worked in a multiplicity of the contractor's operations could be assigned to the corporate home office.

In any of these cases, the Board accepts the fact that the costs associated with these ''homeless'' will bear no relationship to its current activities and the cost would be allocated to intermediate home offices and segments as an residual expense.

The proposed transition provisions address how a contractor's prior accounting practices are to be reconciled with the accounting provisions of the proposed rule. Some contractors who were using accrual accounting prior to becoming subject to the proposed rule will continue to use accrual accounting if the criteria for accrual accounting are satisfied. Likewise, other contractors who had been using the pay-as-you-go method will continue to use the pay-as-you-go method if those criteria are not satisfied. However, special provisions are needed whenever a contractor must change its previously disclosed accounting practice for post-retirement benefit costs.

If a contractor changes from the pay-as-you-go cost method to accrual accounting for contract costing purposes, the transition section of the proposed Standard provides for the establishment of a supplemental transition obligation so that prior SFAS 106 accruals measured during prior periods when the contractor had cost-based Government contracts can be assigned to periods after the contractor becomes subject to the proposed Standard. Once established, the supplemental transition obligation is accorded the same treatment as the SFAS 106 transition obligation. The prior accruals included in the supplemental transition obligation are based on the delayed recognition of the transition obligation regardless of how the transition obligation was recognized for financial accounting purposes. As an alternative to establishing a supplemental transition obligation, the proposed Standard permits these contractors to use a so-called ''fresh start'' approach provided the contractor has continually been performing government cost-based contracts since adopting SFAS 106.

If a contractor switches from accrual accounting to the pay-as-you-go cost method, this proposed Standard requires that the accumulated value of prior unfunded accruals measured during periods when the contractor had cost type or cost-based fixed price Government contracts be carried forward. Like the analogous provision in the amendments to the pension Standard, CAS 9904.412, benefit payments must be charged against the accumulated value of unfunded accruals before pay-as-you-go costs can be measured, assigned to cost accounting periods, and allocated to cost objectives.

If the contractor has an established practice of using terminal funding for its post-retirement benefit costs, that contractor may continue the use of the terminal funding method. A switch from terminal funding to pay-as-you-go accounting is permitted if the criteria for accrual accounting are not met. Any payments previously considered as terminal funding and allocated to cost objectives would not be subject to the fifteen-year amortization requirement. If the criteria for accrual accounting are met and the contractor switches from terminal funding to accrual accounting, then any prior SFAS 106 accruals that exceeded amounts paid for terminal funding may be treated as a supplemental transition obligation

*C. Paperwork Reduction Act*

The Paperwork Reduction Act, Public Law 96–511, does not apply to this proposed rule, because this rule imposes no paperwork burden on offerors, affected contractors and subcontractors, or members of the public which requires the approval of OMB under 44 U.S.C. 3501, *et seq.* The records required by this proposed rule are those normally maintained by contractors who claim reimbursement of post-retirement benefit costs under government contracts.

*D. Executive Order 12866 and the Regulatory Flexibility Act*

Because most contractors must measure and report their post-retirement benefit liabilities and expenses in order to comply with the requirements of SFAS 106 for financial accounting purposes, the economic impact of this final rule on contractors and subcontractors is expected to be minor. As a result, the Board has determined that this rule will not result in the promulgation of a ''major rule'' under the provisions of Executive Order 12866, and that a regulatory impact analysis will not be required. Furthermore, this proposed rule does not have a significant effect on a substantial number of small entities because small businesses are exempt from the application of the Cost Accounting Standards. Therefore, this rule does not require a regulatory flexibility analysis under the Regulatory Flexibility Act of 1980.

*E. Public Comments*

*Public Comments:* This proposed Standard is based upon responses to the Staff Discussion Paper made available for public comment on September 20, 1996, 61 FR 49533. Eighteen (18) sets of public comments were received from contractors, Government agencies, professional associations, actuarial firms, law firms, public accounting firms, and individuals. The proposed Standard is also based upon the ten (10) sets of responses to the Board's letter of January 12, 1999 which was also made available for public comment on February 18, 1999, 64 FR 8141. The comments received and the Board's actions taken in response thereto are summarized below:

1. Need for a Cost Accounting Standard

*Comment:* The industry associations and some contractors expressed the belief that a Standard might not be needed because GAAP, as articulated by SFAS 106 and augmented by CAS 9904.403, 9904.412, 9904.413, and 9904.418, provide full and adequate guidance on the measurement, assignment to periods, and allocation of post-retirement benefit costs. Some commenters expressed the notion that the promulgation of a Cost Accounting Standard on any subject already addressed by a FASB Statement would be superfluous. But, many respondents noted subject areas where SFAS 106 was either inadequate or inappropriate for contract cost accounting purposes and suggested that some CASB guidance would be helpful.

Both contractor and Government commenters generally preferred amendments to the pension Standards, CAS 9904.412 and 9904.413, and possibly the insurance Standard, CAS 9904.416, rather than the promulgation of a new Standard. The commenters unanimously agreed that a Board Interpretation would be insufficient to address the new and complex issues concerning post-retirement benefit costs. Several commenters opined that substantive action should be taken by the Board. SDP Technologies wrote: ''While many technical questions need to be resolved, SDP urges the CASB to pursue this effort and develop a comprehensive solution.'' And, TRW stated, ''the level of detail and range of issues posed in the Discussion Paper highlight the numerous accounting, legal, and practical considerations that must be addressed.'' The OUSD generally concurred when it stated: ''While it is generally preferable to amend existing Standards, a new Standard may be necessary if amendments of existing Standards cannot be accomplished without unreasonably complicating existing Standards.''

In its letter of August 4, 1997, CODSIA submitted a straightforward and simple proposal to illustrate how the Board might address post-retirement benefit costs by amending CAS 9904.412 and CAS 9904.413. CODSIA did not support the development of a separate Cost Accounting Standard on post-retirement benefits on the grounds that it would not be an economical and efficient way to address this issue. The Board also received a letter from the ABA discussing some of the shortcomings of the CODSIA proposal, but which generally favored CODSIA's approach of amending the pension Standards.

*Response:* The Board recognizes the concerns expressed regarding the promulgation of a new Standard. These concerns appear to be driven by fears that a new Standard might be conceptually different from the current pension and insurance Standards. However, the Board has determined that amending CAS 9904.412, 9904.413, and 9904.416 would be extremely cumbersome and would add unnecessary complexity. The Board notes that the FASB did not merely extend Statements 87 and 88 (SFAS 87 and 88) to post-retirement benefits, but promulgated a separate Statement, SFAS 106, building upon the concepts and structures of SFAS 87 and 88. The Board believes that the most manageable approach to providing substantive measurement, assignment, and allocation criteria is the promulgation of a new and separate Standard addressing the costs of post-retirement benefits. The Board does not see any reason to unnecessarily muddy the water for the sake of arbitrarily avoiding the promulgation of another Standard.

The Board believes it is appropriate to promulgate a separate Cost Accounting Standard on a subject matter that the FASB has addressed for financial accounting purposes. The Board notes the CASB Concepts Statement (57 FR 31039) which states:

> The Board will give careful consideration to the pronouncements affecting financial and tax reporting and, in the development of Cost Accounting Standards, it will take those pronouncements into account to the extent it can do so in accomplishing its objectives.

The nature of the Board's authority and its mission, however, is such that it must retain and exercise full responsibility for meeting its objectives.

In this regard the Board must specifically consider what elements constitute a proper measure of post-retirement benefit costs for contract cost accounting purposes.

The Board agrees that SFAS 106 should be used as the baseline for the development of any promulgation regarding post-retirement benefit costs. However, the Board believes that SFAS 106, augmented by existing Standards, does not provide adequate guidance on contract cost accounting for post-retirement benefit costs. The Board proposes to generally accept the terminology, measurement, assignment, and adjustment provisions of SFAS 106. Modifications and restrictions are made only where necessary for Government contract cost accounting purposes. Thus, the Standard being proposed today does modify, augment, and restrict SFAS 106 provisions that are either inadequate or inappropriate for contract cost accounting. This proposed Standard also augments SFAS 106 and existing Standards by addressing the allocation of costs to segments, segment closing adjustments, and the transition from current contract cost accounting practices to this new Cost Accounting Standard for post-retirement benefit costs.

The essence of the CODSIA proposal to amend CAS 9904.412 was simply to add a sentence to subsection 9904.412–40(b) stating that for administrative convenience, the contractor may, at its option, utilize the methodology provided in SFAS 106 to measure the costs of postretirement medical and life insurance costs. The CODSIA approach would permit very different alternative accounting practices for the same category of cost without any justification for having a choice of accounting methods. Such an approach would be contradictory to the Board's goal of uniformity. The Board does not believe that post-retirement benefit costs should be subjected to the pension rules of CAS 9904.412 and 9904.413 that were originally designed and recently amended to coordinate with the vagaries of the tax code. Furthermore, the subject matter and the terminology employed in the current CAS 9904.412 and 9904.413, as compared with SFAS 106, are so different that any attempt to treat them together in a single amended CAS 9904.412 and 9904.413 would produce an unwieldy document that would be difficult to comprehend or implement.

Thus, the Board has concluded that the promulgation of a new Standard is necessary to adequately and clearly address the cost accounting (measurement, period assignment, and allocation) issues unique to post-retirement benefit costs of Government contracts. Having a separate and distinct Standard will make it clear to users and practitioners where the CAS Standards and GAAP are in agreement and where the Standards and GAAP diverge. Promulgating a new and separate Standard will reduce the administrative burden of trying to apply a single pronouncement for two different purposes; to wit, financial reporting and contract cost determination.

2. Relationship to Existing Standards

*Comment:* Generally the respondents agreed that tax consequences should not be considered in the determination of contract cost. The Aerospace Industries Association (AIA) did suggest that if funding were required as a condition of using accrual accounting, the tax consequences might have to be considered ''because funding and tax considerations are irretrievably interwoven.'' The AIA also noted that if the Board ''permits accrual accounting without a funding requirement, tax consequences are generally irrelevant.'' The industry associations and most contractors believed that CAS 9904.412 and 9904.413, possibly augmented by CAS 9904.416, should form the baseline if there were to be a funding requirement. While some industry commenters felt that the Board should consider tax-rate complementary funding, others expressed their belief that tax-rate complementary funding for nonqualified pension plans in CAS 9904.412 is overly complicated. While Government respondents opposed the use of such tax-rate complementary funding, the OUSD did express its belief that ''tax consequences should be considered only to the extent the contractor is unable to fund the entire amount of the accrued cost to a tax deductible funding vehicle.''

Some industry commenters expressed their belief that if funding were to be required for cost recognition, then an ''assignable cost limitation'' would be reasonable, especially if spread-gain actuarial cost methods were permitted. The AIA noted, ''the original CAS Board limited the application of spread gain methods by imposing an assignable cost limitation (see old CAS 412.50(b)(2)).'' Government respondents believed there should be an assignable cost limitation defined similarly to the one used for pensions regardless of whether funding would be required as a prerequisite for accrual accounting.

The Government respondents did not favor any explicit linkage between segment closing adjustments for pension and post-retirement benefit plans. Industry respondents asked that the Board provide that any pension surplus measured under 9904.413–50(c)(12) be explicitly offset against any unfunded post-retirement benefit obligation when a segment closes. Texas Instruments stated:

Conceivably, the same business interruption event that triggers an adjustment to PRB costs will also trigger a similar adjustment to pension costs. Therefore, both these determinations should be connected.

The Department of Defense commenters expressed an interest in amending CAS 9904.416 to reflect the differences between life insurance, medical insurance, and property and casualty insurance. These respondents noted that each of these types of insurance requires unique actuarial approaches and are generally unrelated to each other. They also recommended that the Board review workers' compensation coverage, which includes health, disability and liability provisions. The comments from industry generally stated that they had no major concerns or problems with CAS 9904.416.

*Response:* When developing these proposed modifications to SFAS 106, the Board sought to maintain consistency where practicable with the analogous provisions of (a) CAS 9904.412 and 9904.413 on pensions, (b) CAS 9904.415 on deferred compensation plans, and (c) CAS 9904.416 on insurance costs. However, this proposed Standard addresses the accounting issues of measurement and period assignment of post-retirement benefit costs and does not address tax-deductibility concerns. The recent amendments to CAS 9904.412 and 9904.413 were exceptional in the incorporation of tax-implications into a Standard. The Board recognizes that tax accounting rules can produce volatility and that such tax rules primarily affect the timing of cost recognition. The Board notes that pension accounting and practices, unlike those for post-retirement benefits, evolved in an environment in which funding was not only permitted, but dominated by tax law and Internal Revenue Service (IRS) and Department of Labor regulations regarding the determination of the benefits and the actual funding and administration of pension plans.

In this proposed Standard, the determination of the cost for a period when accrual accounting is used generally follows SFAS 106 with some

restrictions and modifications. SFAS 106 imposes no minimum or maximum limits, such as the assignable cost limitation, on the determination of the net periodic post-retirement benefit cost, and neither does this proposed Standard.[8]

The proposed Standard does not address the offsetting of a post-retirement benefit segment closing adjustment against any pension segment closing adjustment. The Board believes that CAS 9904.413 determines the plan termination and segment closing adjustment for pension plans and this proposed Standard would determine the adjustment for post-retirement benefit plans. How either adjustment is actually transacted or effected is best determined by the contracting parties. This proposed Standard and CAS 9904.413 neither require nor preclude the aggregation of these adjustments with each other or other issues for resolution and settlement purposes.

This proposed Standard addresses many issues similar to those considered in the March 30, 1995 amendments to CAS 9904.412 and 9904.413. The fact that any of these issues are treated differently in this proposed Standard on post-retirement benefit costs does not necessarily imply that changes will be made to the pension Standards, nor does it preclude such possibility.

The Board notes the comments from the Department of Defense regarding a general review of CAS 9904.416, but believes that addressing post-retirement benefits as defined by SFAS 106 is a substantial task in its own right. To expand this case to include a comprehensive review of CAS 9904.416 would make the case unmanageable. The Board proposes that the provisions of CAS 9904.416 relating to prefunding of retiree benefits be replaced by this Standard. Otherwise the Board has concluded that any general review of CAS 9904.416 is outside the scope of this project.

3. Funding as a Prerequisite for Accrual Accounting

*Comment:* The perception that any post-retirement benefit liability recognized in the financial statements might be a ''soft'' liability led some respondents, especially Government respondents, to express the belief that funding must be used as a tool in assessing the firmness of these liabilities.

In general, industry commenters argued funding does not necessarily substantiate the liability. They expressed their belief that funding may be an important business consideration, but such considerations generally deal with cash flow consequences and income tax considerations. They recommended that any criteria established as a prerequisite for accrual accounting should address the existence of the liability rather than the existence of funding. They also believed that funding is an allowability issue, not an accounting issue.

The ABA noted that for financial accounting purposes the threshold for recognition is met by a probability that an obligation exists. The ABA did suggest there may be situations when the funding of the annual accrual might serve a legitimate purpose. The ABA wrote in part:

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

The NDIA also acknowledged that while funding could be one means to substantiate (validate) the obligation, there were disadvantages to using funding for contract cost measurement and assignment.

> It is clear that funding validates a liability. It is also clear that funding does not match cost with products. It is also clear that the use of funding (or any other cash payment) as a determinant of cost incurrence decreases uniformity and consistency in accounting.

Industry representatives pointed out the reason for including a funding requirement in the pension Standards and the inappropriateness of a funding requirement for post-retirement benefits costs. The AIA made the point as follows:

> Public policy, as articulated in the tax code, has long encouraged pension plan sponsors to fund their programs at an adequate level. While industry does not agree that funding has any place in the Cost Accounting Standards, the addition of a funding requirement in the recent changes to CAS 412, as well as explicit recognition of tax deductible limits, did not create tension between public policies as expressed in the Internal Revenue Code and the Cost Accounting Standards. ''In contrast, however, Congress has intentionally discouraged prefunding of post-retirement medical benefits. It would be inconsistent for the Cost Accounting Standards Board to in essence force contractors to fund these post-retirement benefit costs.

On the other hand, in its response to the Staff Discussion Paper, the OUSD articulated the concern of some members of the Government procurement community that any potential risk that the liability might not be liquidated is unacceptable. The OUSD unequivocally stated:

> Yes, funding is necessary to substantiate accrual of costs. The level of funding necessary is 100 percent of the maximum amount of possible funding in accordance with the contractor's funding vehicle. Permitting funding at less than 100 percent of the cost accrual results in a potential risk that the liabilities for which the Government has paid its fair share might never be liquidated. A 100 percent funding requirement assures the Government that the money will be available when the liability must be paid. If there are valid reasons to accrue the liabilities, the accruals should be fully funded. Permitting less than 100 percent funding effectively results in the Government providing a long-term interest free loan to contractors. Permitting funding at less than 100 percent of the cost accrual would require that earnings on the unfunded amounts be imputed each year to preclude increased costs to the Government resulting from lost earnings on the unfunded amounts.

Government respondents stated there are no appropriate alternatives to a requirement that the cost accrual be fully (100%) funded. Generally, industry respondents stated that the Board did not need to consider any alternatives to a funding requirement because funding was unnecessary to substantiate the cost accrual. Boeing concurred with the belief that funding does not necessarily substantiate the liability, but suggested that more restrictive measures of accrual accounting or cash basis accounting might be used where the contractual rights to a benefit are lacking. Boeing commented that:

> The accounting must be based upon the likelihood that the contractor will liquidate the liability. If the likelihood is in some doubt or remote then the costs should be recognized on more limited accrual basis, *i.e.,* terminal funding or those vested, or if not appropriate on a cash basis. Otherwise the costs must be recognized on an accrual basis over the period of time the benefit is earned.

The responses to the Board's January 12, 1999 letter did focus and advance the discussions regarding the role of funding. Most industry representatives continued to argue that funding neither enhances nor proves the firmness of the liability for post-retirement benefits. Some industry commenters expressed the belief that once established, a contractor's promise to provide post-retirement benefits could not easily be avoided and therefore, a funding

[8] As discussed elsewhere, the proposed Standard does compare and limit the net periodic post-retirement benefit cost so that the accumulated value of plan assets and unfunded accruals do not exceed the unavoidable liability, *i.e.,* the nonforfeitable post-retirement benefit obligation.

requirement might be superfluous. Industry commenters again argued that funding was merely a cash-flow or financial management decision and as such, was an inappropriate consideration for an accounting standard. These respondents did believe that funding would be a proper consideration for an allowability rule which addresses procurement policy concerns.

Comments from the Department of Defense Inspector General (DOD IG) and the Department of Energy reiterated the position that full (100%) funding of post-retirement benefit costs should be included in the criteria for accrual accounting. The OUSD maintained its opinion that post-retirement benefit costs must be funded, but agreed with the industry comments that funding should be addressed as an allowability constraint and not within the allocability criteria of an accounting standard.

*Response:* In Standards promulgated by the original CAS Board dealing with pension and insurance costs, in most instances the applicable Standards require that pension and retiree insurance costs be funded. Therefore, the Board believes that to maintain consistency with the promulgations of the original CAS Board and amendments promulgated by the current Board, the Board had to consider the role of funding as a prerequisite for the use of accrual accounting for the costs of post-retirement benefits. The Board considered a criterion for accrual accounting based on the contractor's documented commitment to fund at least the government segments' post-retirement benefit costs. But, after reviewing the merits of assessing the liability's firmness using funding as opposed to the terms of the post-retirement benefit plan, the Board decided to propose criteria concerning the contractor's ability to unilaterally reduce or eliminate benefits.

The original pension Standard, CAS 412, and the March 30, 1995 amendments were developed in an environment wherein the large majority of pension costs arose from qualified pension plans subject to ERISA. For qualified pensions plans there was less concern with whether the pension obligation would be systematically funded as costs are accrued for benefits earned by employees working on Government contracts. Tax accounting, financial accounting and contract cost accounting for pensions mostly differ in the pattern in which tax deductible accruals (contributions), financial accounting expense accruals and the contract cost accruals are ascribed to accounting periods.

Generally CAS 412 did not have to establish the contractor's commitment to fund its tax-qualified pension plan as a prerequisite for accrual accounting, the funding requirement was already imposed by ERISA. Even as far back as 1968 paragraph 42 of APB–8 stated: ''This Opinion [APB 8] is written primarily in terms of pension plans that are funded.'' Conversely, for post-retirement benefits, financial accounting uses ''pure'' accrual accounting while tax accounting for post-retirement benefits is generally limited to cash basis accounting. Thus post-retirement benefits are shown on an accrual basis for the more conservative financial accounting purposes (which tend to maximize liability recognition), but are usually operated on a pay-as-you-go basis.

Despite assertions by some respondents, the original Board did believe that funding played a legitimate role in determining whether the liability for a pension or post-retirement benefit was sufficiently firm for contract cost recognition. In the May 15, 1978 preamble to the Notice of Proposed Rulemaking for CAS 416 (43 FR 20806), the original Board addressed the funding issue when it proposed subparagraph 416.50(a)(1)(v) (which was unchanged when published in the final rule):

> ''One respondent objected to the requirement that costs which represent additions to a 'retired lives' reserve be evidenced by payments to an insurer or trustee. Retired lives benefits are analogous to pension costs in that a contract cost is to be recognized in the present but payment of the benefit is to take place in the relatively distant future. In most such programs, the employer reserves the right to discontinue the program at any time, and benefits are limited to those which can be provided by amounts already funded. If an amount is to be recognized currently as a cost of a retired lives program, there should be some evidence that a contractor has, in fact, incurred a liability which he cannot subsequently avoid by a unilateral decision.
>
> ''Some respondents suggested the deletion of the requirement that the contractor have no right of recapture of the fund as long as any active or retired participant in the program remains alive. Under some fully prefunded programs, a substantial portion of the fund is to provide for liability to active employees. Without the cited provision, it would be possible for the contractor, at any time, to terminate the program as to employees who had not yet retired, thereby creating a surplus in the fund and obtaining a windfall.''

And in Section (1) ''RELATIONSHIP TO THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 AND TO GENERALLY ACCEPTED ACCOUNTING PRINCIPLES'' of the September 24, 1975 preamble to the promulgation of CAS 412 as a final rule (40 FR 43873), the original Board stated:

> APB–8 provides criteria for accounting for the cost of pension plans for financial accounting purposes. The Board believes that certain of these criteria are not appropriate for Government contract costing purposes. For example, a fundamental concept of APB–8 is that the annual pension cost to be charged to expense for financial accounting purposes is not necessarily determined by the funding of a pension-plan. The Board believes that a requirement of law for annual minimum funding of pension costs on an irrevocable basis, is strong evidence that an obligation for at least such period.

The Board went on to state:

> In developing the accompanying Cost Accounting Standard, the Board has attempted to stay within the general constraints of APB–8 and the funding provisions of ERISA.

Later, in Section (11) ''ASSIGNMENT OF PENSION COST'' of the September 24, 1975 Preamble, the Board writes:

> ''Certain commentators expressed their disagreement with the sections of the **Federal Register** proposal dealing with the assignment of pension costs among cost accounting periods. The concept set forth in the proposal related in the assignment of costs to the validity of the liability for such costs. Commentators referred to the concept set forth in APB–8 that the accrual of pension expenses and the funding of pensions are not necessarily related. They stated that cost should be assigned to cost accounting periods irrespective of whether or when funded.
>
> ''The Board believes that assigning pension costs to cost accounting periods on a cash basis is inappropriate from an accounting viewpoint and could lead to the improper assignment of pension costs among periods. **The Board believes also that the concept which states that funding is unrelated to pension accruals is not appropriate for contract costing because, under such a concept, pension costs could be assigned to cost accounting periods and never be funded; yet such costs would be reimbursed by the Government.** (Emphasis added)
>
> ''The underlying concept of the Standard is that when a valid liability exists, the corresponding costs may be accrued irrespective of when the liability is liquidated. If the liability (to the pension fund or, for pay-as-you-go plans, to retirees) is not valid, it cannot be accrued; in order for it to be allocated to cost objectives of the current period, it must be liquidated (funded) in that period or within a reasonable period of time thereafter. In order to clarify its intent with regard to the allocation of pension costs to cost objectives of individual cost accounting periods, the Board has revised the wording of 412.40(c) of the Standard.''

Clearly, the original Board believed that funding was a proper accounting

consideration in promulgating a Cost Accounting Standard. This Board agrees and recognizes that in any case, funding is one method for validating the liability.

The Board also considered adopting the tax-rate complementary funding requirement applicable to nonqualified pension plans. While negating the tax consequences of funding such plans, tax-rate complementary funding adds administrative burden and complexity. Since the amendments to the pension Standards were published in March 1995, it appears that very few, if any, contractors have elected to use the ''tax-complement'' approach. Furthermore, unlike pensions, the funding of post-retirement benefits is not driven by tax law. The Board has concluded that it is inappropriate to develop provisions of this proposed rule based on tax law.

Looking to other accounting standards, an alternative to imposing a funding requirement might be to follow the approach that the National Association of Insurance Commissioners (NAIC) uses for the statutory accounting policy for ''Employer's Accounting for Post-retirement Benefits Other Than Pensions'' wherein the obligation is determined for recognizing only benefits for which plan participants are currently eligible. However, the responses to the Staff Discussion Paper, ''Accounting for Unfunded Pension Costs,'' published on June 17, 1991 (56 FR 27780), argued that such recognition would neither have the simplicity and ease of cash basis accounting nor the matching of costs with activities achieved by accrual accounting. These same comments and criticisms would apply to such an approach for post-retirement benefit costs. The Board disagrees and believes that such a restrictive approach does have merit and can address the issue of whether a firm liability exists. Therefore, the Standard being proposed today imposes a cap on the net periodic post-retirement benefit cost for a period which is based on the firm liability for benefits payable to vested and fully-eligible participants.

There is much confusion, misinformation, and perhaps disinformation, concerning funding as a prerequisite for accrual accounting. The Board believes the question of whether accrual accounting or cash basis accounting should be used to measure, assign and allocate costs to Government contracts is an accounting question within the purview of the Cost Accounting Standards Board. The establishment of criteria concerning when alternative accounting approaches (cash versus accrual) should apply is also an accounting question that the CAS Board can and should address. (See CASB Statement of Objectives, Policies and Concepts published May 1992, after SFAS 87 and 106 were promulgated.) The Board disagrees that requiring funding of the period cost developed under an accrual accounting method converts the funded accrual to cash basis accounting because the primary measurement and assignment is still based on accrual accounting. Although this proposal does not impose a funding requirement, the Board reiterates its belief that funding can be an appropriate criterion to ascertain the contractor's commitment to ultimately provide a promised benefit.

4. Criteria for Assessing the Firmness of the Post-Retirement Benefit Liability

*Comment:* The Staff Discussion Paper asked if the post-retirement benefit liability was reasonably foreseeable and could be reasonably estimated. The response from the National Defense Industrial Association (NDIA) was representative of the comments from both industry and the government when NDIA stated: ''If it can be determined that there is a valid obligation to pay, determining an annual estimate of the cost of that liability is feasible.'' Several commenters concurred with AIA who noted that the FASB had ''considered this issue at length, and concluded that these amounts could be reasonably estimated (see paragraphs 159 through 163 of SFAS 106).'' Towers-Perrin, an actuarial consulting firm, stated that it performs nearly 600 SFAS 106 postretirement benefit plan valuations for nearly 600 clients each year.

Most commenters who addressed the SFAS 106 definition of the ''substantive plan'' stated the definition might be inadequate for contract cost accounting purposes. There appeared to be a general consensus that in order for a post-retirement benefit to be recognizable, criteria similar to that found in CAS 412 requiring that the plan be in writing and communicated to the employees, and that the benefits be materially nonforfeitable should be applied.

However, comments from the industry associations questioned the usefulness of requiring that the post-retirement benefit plan be written as adequate evidence of a firm liability. NDIA argued that the SFAS 106 concept of established practice coupled with employee communication might be more appropriate: ''A written document enhances the likelihood that there is a valid obligation. However, employee notification of future benefits, coupled with a history of payment of benefits, also seems to be substantial evidence of an intent to pay.'' AIA agreed with NDIA: ''A formal document does not make the liability any more compellable than informal documentation or an established practice. A formal document may enhance the auditing of the liability but it doesn't necessarily enhance the validity of the liability.''

Funding as a precondition to the use of accrual accounting remains controversial and was discussed in the previous subsection (3). Other than a funding requirement, no commenters suggested any additional or alternative criteria that might be used to assess the firmness of the post-retirement benefit obligation.

The Staff Discussion Paper also inquired whether the firmness of the liability could be enhanced by not projecting benefit levels. None of the commenters found any utility to placing such a restriction on the recognition of the post-retirement benefit liability.

*Response:* The Board agrees that the liability for a plan that meets the criteria for accrual accounting set forth in this proposed Standard can be reasonably estimated. However, the Board does not believe that a liability is a firm liability simply because it can be estimated. The financial effect of many contingencies can be estimated, but the estimated value associated with these contingencies may not rise to the level of a firm liability for contract costing purposes without meeting other criteria.

The SFAS 106 definition is intended to identify any potential liability for financial accounting disclosure purposes. For contract cost accounting purposes, the Board believes there must be a greater expectation that the benefits will ultimately be paid to the employees. The Board concludes that, at a minimum, when accrual accounting is used for contract cost accounting, the benefits must be described in a formal written document, the right to the benefits must be communicated to the plan participants, and the benefit must be materially nonforfeitable once eligibility is attained. The formal document provides the vehicle by which employees can legally enforce payment of the promised benefits. Furthermore, with the numerous changes that corporations have been making to their post-retirement benefit plans to reduce or eliminate benefits or shift the cost to the employees, the Board believes that only benefits currently provided by the written document and which the contractor cannot unilaterally negate or otherwise eliminate form a firm liability that should be recognized on an accrual basis.

The Board notes that, unlike pension benefits, employees' rights to promised post-retirement benefits often do not vest until the employee approaches retirement eligibility, *e.g.,* age 50 and 20 years of employment. Because of this substantial delay in vesting, a contractor can have a formal, ironclad contractual promise that is communicated to its employees, but still be able to discontinue the plan leaving only those employees who are currently eligible or close to eligibility with rights to post-retirement benefits. This Board, like its predecessor, is concerned that the contractor could reap a substantial gain attributable to the liability released by nonvested participants. The recent court decision in *Sprague* v. *General Motors Corporation,* (Nos. 94–1896, 94–1897, 94–1898, 94–1937, U.S. Court of Appeals, 6th Circuit, January 7, 1998) throws into question the usefulness of relying on established practice, documentation, and communication collectively or individually. Even when the post-retirement benefits are provided pursuant to a collectively bargained agreement, a Circuit Court recently found that the commitment to provide post-retirement benefits does not survive beyond the current bargaining agreement (*Joyce, Charles* v. *Curtiss-Wright Corporation* (1999, CA2, 1999 WL 152535). The Board is aware that a similar systemic weakness in the promise of pension benefits to the employees of Studebaker Corporation was a major impetus for the enactment of ERISA in 1974.

The Board examined how the earning of post-retirement benefits is attributed to cost accounting periods by the actuarial cost method employed by SFAS 106. The Board also considered the ERISA and DOL rules which require that pension benefits, once earned, cannot be reduced by the plan sponsor. For accrual accounting, this proposed Standard similarly requires that the portion of the post-retirement benefit for which the employee has achieved eligibility cannot be eliminated or reduced by the unilateral action of the contractor.

Because the Board does not accept the SFAS 106 substantive plan as the basis for the recognizable liability and has chosen not to use funding to substantiate the cost, the proposed rule relies on the nonforfeitable portion of the accumulated post-retirement benefit obligation as the measure of the valid, that is, compellable, liability. To accomplish this, the proposed rule imposes a limitation on the post-retirement benefit cost measured for a period. The proposed limitation is measured as the benefits paid during the period plus the unfunded amount of nonforfeitable accumulated post-retirement benefit obligation. The amount of valuation assets is the fair value of plan assets plus the accumulated value of unfunded accruals minus the accumulated value of prepayment credits. The proposed rule further requires that the measurement of nonforfeitable accumulated post-retirement benefit obligation include nonforfeitable benefits that would be earned during the year.[9]

5. Identification of the Post-Retirement Benefit Plan

*Comment:* Industry and Government commenters alike argued that the Board should permit the use of different accounting methods for different benefits because a post-retirement benefit plan often is not a single-purpose, homogeneous plan. As the AIA expressed it:

> One area of difference between pensions and post-retirement benefits concerns the definition of a single ''plan.'' While the contracting parties must be clear as to the underlying benefits that are reflected in contract costs, and how amounts funded or accrued relate to those individual cost elements, industry feels strongly that the CAS Board should not require contractors to restructure their plans from an ERISA perspective in order to achieve effective cost allocation. In other words, form should not be elevated over substance with regard to plan structure.

The OUSD summed it up this way:

> If separate plans are used to provide different types of post-retirement benefits, different accounting methods should be permitted. Different accounting methods also should be permitted for different benefits provided through the same plan, but only if separate records are maintained. Different accounting methods generally should not be permitted for different groups within the same plan population (*e.g.,* union versus non-union). However, if contractors are permitted to use cash accounting for current retired employees and accrual accounting for active employees, the treatment of post-retirement benefit costs for future retirees must be on an accrual basis. Since the post-retirement benefit liability would have already been accrued during the period of active employment, there is no additional liability to be recognized when active employees retire.

Most commenters felt that immaterial benefits, *e.g.,* legal services, retiree discounts, etc., could be accounted for by the contractor in any reasonable manner. They stated that, as with any item of cost, the CAS should only address costs that are material.

*Response:* The Board agrees. The Board is aware that it is often necessary for a company to use a combination of investment vehicles, *e.g.,* a Voluntary Employee Benefit Association (VEBA) trust combined with an IRC § 401(h) trust, to achieve tax-favorable funding of post-retirement benefits. Similarly, slightly different retiree insurance plans may be required in different plants, locations, or states to provide an overall general post-retirement benefit promise. Thus, the post-retirement benefit plan is frequently not a single benefit plan, but several different benefit promises to different groups of employees.

The proposed Standard permits the contractor to parse its overall post-retirement benefit plan or its plan population into several separately identified plans for purposes of contract cost accounting. Once so established, such division of the plan or population must be consistently maintained and often will require disclosure on the DS–1 Statement. For administrative ease, the proposed Standard also allows the contractor to aggregate different plans or populations for which the same contract cost accounting method is used.

Costs of post-retirement benefits that are immaterial may be accounted for separately on a consistent basis. This proposed Standard does not address post-retirement benefit costs that are immaterial.

6. Cash Basis Accounting (Pay-as-You-Go Cost Method and Terminal Funding)

*Comments:* Many commenters expressed their belief that cash basis (pay-as-you-go) accounting is appropriate whenever the post-retirement benefit liability is not firm. Some commenters expressed a desire for cash basis accounting to be permitted even when the criteria for accrual accounting are satisfied so that contractors could maintain the flexibility to coordinate their contract cost accounting with their financial management decisions regarding the funding of the liability. Other commenters asked that cash basis accounting be permitted as an alternative if a funding requirement were to be imposed as a prerequisite to accrual accounting.

The commenters who addressed terminal funding stated that while terminal funding was not an acceptable accounting method, the Board should permit contractors to continue use of the terminal funding method.

*Response:* The Board generally agrees. Therefore, this proposal provides that if the post-retirement benefit plan does

[9] Including the additional nonforfeitable post-retirement benefit obligation accrued during the year is analogous to, but more straight-forward than, measuring and adding a nonforfeitable annual service cost.

not satisfy the criteria for accrual accounting, then cash basis accounting is the only appropriate cost accounting method. However, this proposed Standard requires that if the plan does meet the proposed criteria for accrual accounting, then the contractor must use accrual accounting.

The Board agrees that terminal funding is not a generally acceptable accounting method and may introduce excessive volatility into costs. This proposal does not permit contractors to use the terminal funding method, although the transition provisions permit a contractor who has an established practice of using terminal funding to continue such practice.

As discussed later, if the plan fails the criteria for accrual accounting, the Board believes it is inappropriate to recognize any unfunded liability that may exist when a segment closes.

7. Accounting for the Funding of Post-Retirement Benefit Plans

*Comment:* The commenters generally agreed that any portion of the accrued cost for the period that is not funded should be accounted for in some manner. The commenters suggested that the provisions of CAS 9904.412 regarding unfunded accruals could serve as appropriate guidance. The NDIA suggested that some restrictions might be placed on the interest equivalent used to update the accumulated value of the unfunded accruals. The OUSD recommended that the accumulated value of the unfunded accruals be reduced appropriately when post-retirement benefits are paid.

*Response:* The Board agrees with these comments. For plans using the pay-as-you-go cost method, funding is accomplished by payments made directly to the participant or else to a third party to provide service or insurance for the participant. The cost of defined-contribution plans using accrual accounting is measured by the net distribution to individual participant accounts of the amount deposited to the funding agency or paid to cover the administrative expenses of the plan. Interest expenses or other costs of borrowing are excluded from post-retirement benefit costs. For defined-benefit plans using accrual accounting, deposits to the funding agencies plus benefits paid to or on behalf of participants comprise the funding. When accrual accounting is used, the Board believes that contractors who pay benefits directly from corporate resources should be accorded the same treatment as contractors who would make a deposit to a funding agency and then almost immediately use that funded deposit to pay benefits.

Depending on its financial management decisions, a contractor's actual funding may be more or less than its assigned post-retirement benefit cost, therefore the proposed measurement and assignment section includes provisions to account for unfunded accruals and prepayment credits. The Board proposes that any portion of the period accrual that is not funded shall be accounted for and accumulated with interest as an accumulated value of unfunded accruals. Generally the accumulated value of unfunded accruals would be treated the same as a plan asset.

This proposed Standard specifically provides that prepayment credits are not allocated to segments until used to fund the post-retirement benefit cost in a future period. When a portion of the prepayment credit is used to fund post-retirement benefit cost, that portion will be allocated as part of the total funding for that cost accounting period. This means that the paragraph 9904.419–40(b)(5)(iii) balance tests would not include the prepayment credit when applied at the segment level.

Consistent with the pension Standard, CAS 9904.413, a contractor may choose to allocate funding to those segments, including home offices, that allocate costs to contracts subject to this Standard before allocating any funding to other segments. This proposed provision gives contractors flexibility to comply with any funding requirement that might be imposed by procurement allowability rules. Post-retirement benefit plans, like nonqualified pension plans, are not subject to plan-wide minimum funding requirements so that funding the Government segments first could create a situation where those segments are fully funded while the commercial segments are unfunded. The Board is concerned that because all participants generally would have a claim to any assets of the plan, the Government could, in fact, be subsidizing the obligations of commercial operations and therefore funding must then be applied to those segments once the Government segment(s) is funded. Note that in Illustration 9904.419–60(d)(6), the contribution in excess of the minimum required to fund the cost of the Government segments was allocated toward the funding of the commercial segments rather than as a prepayment credit for the Government segments.

If the criteria for accrual accounting are satisfied, this proposed Standard provides that the full post-retirement benefit cost be allocated to segments based on either a separate calculation of costs or general allocation using an appropriate base, *e.g.,* headcount or salaries, etc. Once the post-retirement benefit cost is allocated to segments and intermediate home offices, this proposal provides that the cost be allocated to intermediate and final cost objectives in the same manner as other personal service compensation costs of that segment or home office.

8. Accounting for the Assets of Post-Retirement Benefit Plans

*Comment:* Both Government and industry respondents found IRC Section 401(h) accounts within a qualified pension trust, VEBA trusts, and secular trusts to be acceptable trust arrangements. Industry respondents believed that ''rabbi'' trusts would be acceptable funding agencies for post-retirement benefit plans just as they are acceptable for nonqualified pension plans under CAS 9904.412. The AIA advised the Board that ''any Standards should permit the use of these and other new arrangements as they emerge.'' Government respondents expressed their belief that any trust arrangement must not be subject to the claims of creditors and therefore objected to ''rabbi'' trusts. The DOD IG stated:

> CAS 9904.416.50(a)(1)(v)(B) requires that there be no right of recovery from a trust by the trustor as long as any active or retired participant in the program remains alive unless the interests of such remaining participants are satisfied through reinsurance or otherwise. This provision has served to adequately restrain contractors from attempting to cost contingent liabilities in current costing periods.

Some industry respondents believed there was no accounting difference between treating IRC Section 401(h) separate accounts as the assets of a post-retirement benefit plan or the assets of an ancillary benefit that is an integral part of the pension plan. On the other hand, the OUSD said:

> Separate 401(h) accounts should be considered part of the post-retirement benefit plan assets because the assets are segregated in a trust and they are restricted by the IRC to be used solely for post-retirement benefits. This is consistent with the description of post-retirement benefit plan assets contained in paragraph 63 of SFAS 106.

Commenters noted many insurance arrangements, *e.g.,* restricted insurance reserves, separate investment accounts, trust owned life insurance (TOLI) arrangements, that might qualify as funding agencies. While they agreed that all insurance arrangement should be considered, they also agreed that access to the assets must be restricted. In this regard, the commenters

expressed a belief that a corporate owned life insurance (COLI) arrangement should not be considered a funding vehicle because a COLI is an unrestricted investment of the company and not the post-retirement benefit plan. The Government respondents believe insurance arrangements must be subject to the same criteria as trusts. The OUSD echoed their concern about ''rabbi'' trusts and stated, ''Insurance arrangements should be permitted to the extent the assets are protected from general creditors and cannot be used at the contractor's discretion.''

The commenters agreed that several funding agencies could be combined to form the assets of a post-retirement benefit plan. No one believed that any particular type of funding agency should be given preference or priority.

*Response:* This proposed Standard on post-retirement benefit costs adopts the CAS 9904.412 definition of funding agency. Any investment vehicle or arrangement and any insurance product or reserve that satisfies that definition can be recognized as an asset of the post-retirement benefit plan. Several individual arrangements, such as a VEBA trust, a TOLI arrangement, and an IRC section 401(h) subaccount could be aggregated together to form the plan assets. The Board expresses no preference for one arrangement over another.

The Board is not concerned about the use of ''rabbi'' trusts. If a ''rabbi'' trust meets the funding agency definition, the plan participants' and beneficiaries' rights are superior to that of the contractor. Because the procuring agencies are responsible for ensuring that their contractors are financially viable, the Board does not perceive any undue risk to the Government that should affect this proposed accounting Standard.

9. Measurement and Assignment Under the Accrual Accounting Method

*Comment:* The commenters were in general agreement that accrual accounting is the most desirable accounting method for determining the costs of post-retirement benefit plans that meet the criteria for establishing a firm liability. They uniformly observed that accrual accounting affords the best matching of post-retirement benefit costs with the contract activity.

None of the commenters favored limiting the measurement and period assignment of post-retirement costs to a single accounting method. In addition to the firmness of the liability, the commenters expressed their belief that the choice of the appropriate cost accounting method would depend on the nature of the post-retirement benefit plan, the financial management of the plan, and factors affecting a particular industry and employee population. As AIA observed:

> CAS consistency and uniformity is referring to identical treatment under like circumstances. In this area, it is highly unlikely there will be like circumstance. Contractors are different, plans are different, IRS rules are changing and the health care environment is extremely dynamic. A ''one size fits all'' uniformity is not appropriate for measuring, assigning or allocating this type of cost.

Similarly, TRW stated:

> Due to the different characteristics of post-retirement benefit obligations (for example, the magnitude of the obligation or the ability to fund in a tax-effective manner), a contractor should be free to determine which method is most appropriate.

*Response:* The Board generally agrees that accrual accounting does provide the best matching of costs associated with a firm liability with contract activities. Therefore, for a post-retirement benefit plan that meets the criteria set-forth in this proposed Standard the contractor must use accrual accounting. Post-retirement benefit plans that do not meet the proposed criteria must use cash basis accounting.

10. Actuarial Cost Methods and Assumptions

*Comment:* Looking to SFAS 106 as the primary model, some respondents have implicitly advocated the use of a single method; that is, the unit credit cost method. Other commenters, concerned with matching costing and funding to the greatest degree possible, advised the Board to permit any generally accepted actuarial cost method, including spread-gain methods. Discussing why spread-gain methods should be permitted, TRW suggested:

> Spread-gain methods should be allowed because they frequently are the basis for determining deductible contributions to *401(k)* [Sic] accounts and VEBAs. If only immediate gain methods are permitted, many contractors will find it difficult if not impossible, to match permitted funding with the expense accrual.

Echoing TRW's comment, the AIA recommended ''flexibility to follow tax rules is critical if funding is to be a prerequisite for cost allowability.'' The AIA went on to suggest that ''changes in the techniques used from one year to the next should not be treated as accounting changes.''

Respondents also commented that the Board should consider addressing actuarial assumptions, especially those used for discount rates and medical cost inflation rates. They were concerned that the SFAS 106 emphasis on current period results, rather than long-term expectations, would cause volatility in annual costs. Several commenters recommended that the assumptions be subject to the same ''best-estimate,'' long-range expectation criteria as the actuarial assumptions used for pension costs. The ABA was adamant that the Board should ''refrain from mandating actuarial assumptions.'' None of the commenters felt that any certification by the plan's actuary or any sensitivity analysis was necessary.

Some commenters held the view that changes in actuarial assumptions should not be treated as a change in cost accounting practice. Other commenters stated that if the basis for actuarial assumptions is changed, rather than the numeric values of assumptions themselves, such changes would appear to meet the criteria of CAS 9903.302 as a change to a cost accounting practice. One commenter added that the Standards need not include guidance already provided for in the regulations.

*Response:* As part of its acceptance of SFAS 106 for the measurement of post-retirement benefit obligations and costs, the Board accepts the SFAS 106 provisions regarding actuarial assumptions. The Board does remain somewhat concerned that currently post-retirement benefit plans are generally unfunded or significantly underfunded. Furthermore, there are no insurance products available to settle the liability for health care benefits. Therefore assumptions regarding expected discount rates cannot be based on the results of actual fund yields nor are there any insurance contracts from which discount rates can be extracted.

The Board notes that the amended CAS 9904.412 prohibits the use of spread-gain methods. Furthermore, when CAS 9904.412 was promulgated, the original Board was concerned that spread-gain methods did not separately identify gains and losses and explicitly imposed a form of assignable cost limitation on costs determined under a spread-gain actuarial cost method.

The Board concurs that post-retirement benefit costs are not sufficiently distinct from pensions and insurance to warrant any special actuarial certification. The Board also notes that when an actuary performs a post-retirement benefit valuation or advises contractors concerning their plans, the actuary is personally subject to the professional standards promulgated by Actuarial Standards Board. The Board has concluded that no special certification requirements are necessary.

The Board proposes to expand the provisions of CAS 9904.416 that require the accrual cost of prefunded retiree insurance plans be ''actuarially determined'' and move these provisions to this proposed Standard. By accepting SFAS 106 as the basis for the actuarial determination of the accrual accounting costs for defined-benefit post-retirement plans, the Board is accepting the unit credit actuarial cost method as described in SFAS 106. The proposed Standard does not preclude the contractor from using a spread-gain actuarial cost method to determine the annual contribution to a tax-qualified funding agency, but the contract cost determination is limited to the unit credit cost method as described in SFAS 106.

What constitutes a change in cost accounting practice should be determined in accordance with the provisions of CAS 9903.302. Those provisions describe cost accounting practices as ''* * * any disclosed or established accounting method or technique which is used for allocation of cost to cost objectives, assignment of cost to cost accounting periods, or measurement of cost.'' Additional guidance regarding the disclosure of cost accounting practices applicable to post-retirement benefit plans is provided in Part VII of the Disclosure Statement (Form CASB DS–1 (Rev 2/96)). The DS–1 guidance makes clear that any disclosure only applies to the basis for setting and updating significant actuarial assumptions. Such disclosure does not apply to the current numerical values of the actuarial assumptions which may change in response to experience. On the other hand, a change in the basis used for determining actuarial assumptions would constitute a change in cost accounting practice that should be addressed on a case-by-case basis under the provisions of CAS 9903.302. Additional provisions in this proposed Standard are not deemed necessary.

The Board proposes to place a restriction on the health care trend rate assumption. The proposed limit is implemented by imposing a cap on the health care trend rate equal to the long-term expected rate of return. Of all the actuarial assumptions, the health care trend rate is one of the most volatile and difficult to estimate. Moreover, many economists and other experts do not believe that health care expenditure can continue to increase as a percentage of Gross Domestic Product. Therefore, the Board believes that this restriction will not only reduce volatility, but will introduce a long-term reasonability [10] limit on this problematic assumption. The Board does note that increases in the projected and accumulated post-retirement benefit obligations that are attributable to a period of high health care cost increases will be measured and recognized as an actuarial loss.

11. Accounting for the Transition Obligation

*Comment:* Both industry and Government commenters agreed that if a firm liability exists, then the transition obligation portion of the total liability is a firm liability and should be included in any accrual accounting provisions promulgated by the Board. The commenters noted that both the original and amended CAS 9904.412 identify the initial unfunded liability, which is analogous to the SFAS 106 transition obligation, as one of the portions of unfunded actuarial liability to be recognized and amortized. Similarly, CAS 9904.416 recognized and amortized the actuarial present value of benefits for employees already retired when contractors switched from the pay-as-you-go cost method to the terminal funding method. The commenters generally agreed that immediate recognition of the transition obligation would be disruptive to contract cost accounting. The commenters recommended that the transition obligation be amortized over either a period of 10 to 30 years as required by CAS 9904.412 or else over the average future working lives of the participants as required by SFAS 106.

One commenter argued for some mechanism to reflect the contractor's historical level of cost-based contracts as a means of achieving equity for both parties if there had been a major increase or decrease in the contractor's cost-based Government work over the last ten (10) years. Another commenter suggested that the contractor and the cognizant Federal agency official should be given the latitude to negotiate such an equitable arrangement. Other commenters opined that attempting to reflect past levels of Government participation in costs assigned to future periods would be exceedingly complicated and would impose an administrative burden for both parties.

*Response:* Consistent with the conceptual approaches of CAS 9904.412, SFAS 87 and SFAS 106, the Board agrees that if the post-retirement benefit plan meets the criteria for accrual accounting, the transition obligation should be recognized in accordance with SFAS 106. However, immediate recognition of the transition obligation, as permitted by SFAS 106, would be unmanageable and disruptive to the budgeting process for cost type contracts and the forward-pricing process for negotiated fixed price contracts. The Board proposes to limit recognition of the transition obligation to the delayed recognition method of paragraphs 112 and 113 of SFAS 106.

Neither CAS 9904.412 nor CAS 9904.416 includes any provision to reflect past levels of Government contracting prior to the initial recognition of the prior service liability. Furthermore, the Board views the granting of prior service benefits, which creates the transition obligation, as an inducement or compensation for current and future employment. Accordingly the transition obligation component is to be allocated to the final cost objectives of the period in the same manner as the other five post-retirement benefit components.

12. Accounting for Annual Gains and Losses

*Comment:* The commenters generally recommended that annual gains and losses (also referred to as experience gains and losses) should be amortized. Industry representatives preferred the gain and loss provisions of SFAS 106, while the Government representatives preferred the 15-year amortization period used in CAS 9904.413 and CAS 9904.416. The commenters agreed that immaterial gains and losses could be recognized immediately.

*Response:* As with the other components of post-retirement benefit costs, determination of the annual gain and loss component will follow the provisions of SFAS 106. However, the annual gain and loss measures the experience of a specific cost accounting period and the Board believes that it is inappropriate to inordinately delay contract cost recognition. Therefore, the proposed Standard requires that the full amount of the annual (experience) gain and loss for a cost accounting period be amortized, not just the portion in excess of the corridor established by SFAS 106. The proposed Standard permits the full current period recognition of any immaterial annual gain and loss. Once the contractor has established its policy for recognizing annual gains and losses, the proposed Standard requires the contractor to consistently follow that amortization policy in the future as part of its cost accounting practice. Similar

[10] The Board has generally accepted the SFAS 106 guidance on actuarial assumptions which places more emphasis on current conditions rather than long-term expectations. However, in this instance, placing a long-term expectation on the health care trend rate which can exert such a leveraging effect on post-retirement benefit costs seems appropriate.

to the provisions of paragraph 9904.412–50(a)(3), the established policy regarding the recognition of annual gains and losses can be dependent upon the size and nature of the gain or loss.

13. Recognition of Other Changes in the Accumulated Post-Retirement Benefit Obligation

*Comment:* Industry representatives recommended that any gain or loss due to a change in actuarial assumptions or a change in actuarial cost method need not be separately recognized from other causes of the annual gain or loss in accordance with SFAS 106, while the Government representatives suggested the gain and loss amortization rules of CAS 9904.412 should be followed. Similar recommendations were made regarding a change in the benefit provisions of the post-retirement benefit plan.

The commenters agreed that the SFAS 106 market-related value of assets should be used to determine the annual gain or loss. They noted that the market-related value of assets, like the somewhat analogous actuarial value of assets for pensions, helps smooth gains and losses from period to period. The commenters also acknowledged that the actuarial cost method, including the method of determining the market-related value of assets, is part of the contractor's cost accounting practice.

*Response:* Gains and losses due to changes in the actuarial assumptions, the actuarial cost method, or the benefit provisions of the plan are to be determined in accordance with SFAS 106. The Board notes that although the actuarial cost method is prescribed by SFAS 106, substantive changes in the manner in which the actuarial cost method is applied, such as a change in the attribution pattern or in the method of determining the market-related value of assets, would constitute a change in cost accounting practice.

The annual gain and loss includes the effect of actual experience deviating from expected changes in assets and demographics. Under SFAS 106 and this proposed Standard, this component also includes the effects of changes in actuarial assumptions. The Board notes that in CAS 9904.412 the cost effects of changes in actuarial assumptions are determined and amortized separately from the effects of annual experience. This higher level of visibility allows the contractor and the Government to assess the continuing reasonableness of the assumptions in the aggregate. However, because the Board proposes to accept and rely on the assumptions used for SFAS 106, this higher visibility would not seem to serve any function in this proposed Standard and no separate identification of the effect of a change in actuarial assumptions is required.

14. Allocation of Post-Retirement Benefit Costs to Segments

*Comment:* Industry respondents generally expressed a belief that CAS 9904.403 provides sufficient guidance on allocating post-retirement benefit costs to segments. Government respondents suggested that allocation guidance similar to that contained in paragraph 9904.413–50(c)(1) might be needed. The commenters agreed that the allocation method would not necessarily be dependent on the accounting method employed. They did acknowledge that the causal-beneficial relationship between the employees of a segment and the benefits provided to those employees by the post-retirement benefit plan should be a factor in determining the proper allocation basis.

*Response:* The Board agrees and this proposed Standard on post-retirement benefit costs contains provisions analogous to those found in CAS 9904.413. The Board believes that the guidance provided in this proposed Standard regarding the allocation of post-retirement benefits costs to segments is compatible with the allocation process applicable to central payments or accruals as outlined in paragraph 9904.403–40(b)(4). The Board notes that post-retirement health care costs often will be appropriately allocated on a head-count basis as opposed to most pension costs which are related to benefits that are salary-related. The Board proposes that the costs of plans using the pay-as-you-go cost method be allocated to segments and home offices having participants and beneficiaries eligible to receive benefits so that the cost is allocated to the segments where the benefits had been earned, *i.e.,* a new start-up commercial segment will not absorb costs of participants who had retired from a historically Government segment.

The Board concluded that consistent with its decision to accept the measurement and assignment provisions of SFAS 106 and to permit contractors to use the data produced for financial accounting purposes, this proposal will in some instances permit a contractor to apply a general allocation of the total plan cost to segments in spite of the inherent, but immaterial, inaccuracy.

15. Separate Calculation of Post-Retirement Costs of Segments

*Comment:* The respondents generally agreed that separate computation of cost at the segment level should be required whenever demographic, benefit, or experience differences cause material differences in the post-retirement benefit cost of the segment. Government respondents pointed out that such guidance is already a part of the pension and insurance standards, notably at paragraphs 9904.413–50(c)(2) and 9904.416–50(b)(1) and (2). Texas Instruments observed:

> Differences in demographics or other factors may support a separate calculation of post-retirement costs at the segment level. In addition, such a segmented approach may be useful in recognizing acquired groups of employees as well as variations in union contracts, benefit levels, etc. In many cases, however, continued use of composite methodology would remain appropriate.

Although separate computations by corporate division are fairly commonplace, the commenters supported requiring separate computation only when the post-retirement benefit cost for a segment would be materially affected. AIA made the point as follows:

> ''We also feel that the following excerpt from the prefatory comments to the old CAS 413 remains appropriate:
>
> 'The Board believes that, in most cases, it will be obvious to the contracting parties whether the presence of one or more of these conditions for a segment will materially affect the pension cost for that segment * * * The Board emphasizes that separate calculations are not routinely required, even though no two segments are likely to be identical with respect to the actuarial factors set forth in the Standard.' ''

The respondents did support the creation of special segments for retired or other inactive plan participants. They suggested that paragraph 9904.413–50(c)(9) would serve as an appropriate model. AIA noted that ''this method, which has been present in CAS 413 for nearly 20 years, has been of considerable aid in facilitating allocation of pension cost.''

*Response:* The Board generally agrees. The proposed Standard adopts the separate calculation requirements of CAS 9904.413. Looking to CAS 9904.413 for consistency and guidance, the proposed Standard does require separate computations whenever certain conditions exist or certain events occur that can be expected to cause a material difference between a general allocation and a separate calculation of post-retirement benefit cost.

The Board considered requiring that post-retirement benefit costs always be

individually calculated for each segment. There would have been an exemption permitting costs to be determined for the plan as a whole and then allocated across the segments if such composite computation and general allocation did not produce materially different results as compared to the cost separately calculated for the segment. When CAS 9904.413 was written in the 1970's, actuarial valuations involved extensive and expensive manual computations. Now that actuaries use high-speed computers to do the basic annual valuation computations, it is standard practice for an employer to have valuation results produced for subgroups of employees by division or subsidiary, often using differing sets of assumptions by location when warranted. The primary advantage of separately calculating post-retirement benefit costs would be achieving the most accurate determination of the benefit obligation and cost for the particular employees of a segment. However, the Board found no material advantage to requiring separate calculations if there were no material effect on contract cost determination.

The Board also considered a general requirement that costs be separately calculated whenever such a separate calculation would yield a materially different result from a general allocation of costs. But this requirement could cause a contractor to produce the separate calculation in order to assess if a material difference would occur. Therefore, the Board found no particular advantage to such a requirement.

This proposed Standard does not provide for nor permit the use of inactive segments. Instead, consistent with the general concept that costs associated with retired and terminated employees should be regarded as a general cost of doing business, each nonactive participant must be assigned to the appropriate segment, an intermediate home office, or corporate home office.

When the pension Standard, CAS 9904.413, was developed, a common practice for pension plans funded or operated through insurance company products, such as, deposit administration contracts or immediate participation guarantee contracts, was to either purchase annuities as participants retired or to move the participants to a separate account or ''retired life reserve'' which effectively annuitized the participants' benefits. To alleviate the administrative expense associated with tracking retirees by the segment from which they retired, CAS 9904.413 emulated this concept of a retired life reserve by permitting retirees, and other terminated participants, to be transferred to an inactive segment. The advent of computer-based participant data systems has eliminated most of the administrative work associated with tracking plan participants and such a provision is no longer needed. The Board also is aware that the creation of a non-operational segment is contrary to the 9904.403–30(a) definition of a ''segment'' and has frequently caused confusion for contractors and auditors.

16. Accounting for the Assets Allocated to Segments

*Comment:* Industry commenters generally expressed that if funding were to be required, then the Board should include a provision allowing Government segments to be funded first. They noted that with the lack of tax-advantaged funding, such a provision might enable a contractor to fully fund the portion of post-retirement benefit cost allocated to Government segments. The NDIA noted, ''if contractors could recover through Government contracts funds set aside for post-retirement benefits, there would be some incentive to fund.'' The AIA felt such a provision was of particular importance to a contractor who performed primarily commercial work. The AIA wrote: ''In addition, if contractors that are primarily commercial are not permitted to fund only their segments performing government work, those contractors will be placed at a relative disadvantage compared to contractors that are devoted exclusively to government contracting.'' The DOD IG concurred stating:

> For the benefit of covered employees, it is most desirable to fund all segments. However, for contract costing purposes, it is acceptable to fund only those segments performing work under Government contracts.

Generally industry respondents opined that memorandum records could provide sufficient evidence of such segmented funding. The DOD IG cautioned:

> Our experience in reviewing CAS 9904.413–50(c)(7) records on business combinations is that memorandum records are adequate only if they are subject to close scrutiny and complete audits by the Government.

Many respondents believed that trust and plan documents could be drafted so that the Government and commercial segments could be effectively covered by separate plans. But they were concerned that such legal separation of the segments would require extra effort, could create employee relations problems, and might run afoul of nondiscrimination rules.

Concerning transfers between funded and unfunded segments, the respondents generally agreed that rules could be drafted, but it might be extremely difficult to draft rules that would be equitable and would not be overly complicated. The OUSD suggested that instead of transferring assets and liabilities with participants, ''any liability resulting from prior service should remain with the segment from which the employee is transferred.''

The commenters also believed that the methods of CAS 9904.413 regarding the initial allocation of assets to the segment and the subsequent annual update would provide ample guidance for post-retirement benefits plans.

*Response:* The proposed Standard adopts the CAS 9904.413 provisions regarding the initial allocation and subsequent update of assets for contractors that use accrual accounting and separately calculate post-retirement benefit cost for segments.

While the proposed Standard does not impose a funding requirement, this proposal permits contractors to fulfill any funding requirement that might continue to be imposed by procurement regulations regarding allowability for only those segments and home offices that allocate costs to Government contracts. This provision will enable many, if not most, contractors to align the funding of their post-retirement benefit costs with the segments that generate income from cost-based Government contracts.

Commercial segments that are not funded would record a memorandum record and account for their costs as an accumulated value of unfunded accruals. When plan participants transfer between segments, this accumulated value of unfunded accruals would be treated the same as plan assets. The requirement to separately account for the assets of each segment will enable this provision to function in a fairly simple and straightforward manner.

The Board also proposes explicit guidance on how assets and liabilities are treated when segments are split or combined. Regarding transfers, the Board believes that the unamortized portion of an employee's accumulated post-retirement benefit obligation is compensation for future service and should follow the employee. Accordingly, the proposed Standard provides that plan assets, the accumulated value of unfunded accruals, and the accumulated value of prepayment credits shall be transferred

in proportion to the employee's accumulated post-retirement benefit obligation.

17. Accounting for Curtailments, Settlements, and Special Termination Benefits

*Comment:* Industry commenters generally agreed that because a benefit curtailment or liability settlement does not disrupt the contractual relationship between the parties, there was no need for a special immediate period adjustment. Most commenters felt that curtailments and settlements should be accounted for as gains or losses.

The OUSD expressed a belief that accounting treatment similar to that contained in paragraph 9904.413–50(c)(12) should be provided for the effects of a post-retirement benefit curtailment, liability settlement, or plan termination whenever accrual accounting had been used. The OUSD also recommended that the unamortized portion of the initial unfunded liability, *i.e.,* the transition obligation, be excluded from the determination of the adjustment. Like industry, the OUSD believed that the Board should permit the plan termination or benefit curtailment adjustment to be amortized if the contractual relationship continued.

Industry commenters expressed their belief that the Government can protect its interests when a post-retirement benefit plan is terminated through provisions similar to the pension plan terminations or segment closing adjustments of CAS 9904.413. They believe that such a provision could provide the Government adequate protection so that a funding prerequisite for accrual accounting might not be necessary. And, they stressed that the Government should recognize its responsibility in regard to underfunded plans. As the NDIA explained:

> Industry commenters generally emphasized that the Government has a responsibility to share in any underfunding as well as any surplus when accrual accounting had been used. Some industry commenters indicated a belief that the Government should share in the underfunding of post-retirement benefit plans that had been accounted for using the pay-as-you-go cost method.

Both industry and Government respondents agreed that the contracting parties are in the best situation to determine whether the adjustment should be effected in the cost accounting period when the plan termination occurs or amortized over several periods with an interest adjustment. Some commenters opined that the option to spread the adjustment should reflect whether or not there is a continuing contractual relationship. The OUSD felt that the choice to immediately adjust or amortize should be at the Government's option. Similarly, TRW believes that the cognizant Federal agency official is in the best position to determine whether immediate adjustment or amortization is appropriate.

*Response:* The Board proposes that any benefit curtailment, liability settlement, or special termination benefit gain (or loss) be measured and first used to offset against unrecognized losses (or gains) in accordance with SFAS 106. While SFAS 106 would then recognize any remaining gain or loss as current period income or expense, the proposed Standard provides that the residual gain or loss be amortized over 10 years as long as the contractual relationship continues. If the segment is closed, any unamortized portion of any curtailment, settlement, or special termination benefit gain or loss is subsumed in the segment closing adjustment.

In this proposed Standard, the Board is presuming that the possibility of any inequity because of a change in the level of government contracting over the ten year amortization period is an acceptable risk when compared to the disruption that would be caused by a repricing of contracts. An additional inequity might occur because the effect of the curtailment, settlement, or termination benefits would not be reflected in currently priced cost-based fixed price contracts during the first few periods of the ten year amortization period. As this case has progressed, the Board's concern about not repricing has increased because of the magnitude of the recent benefit curtailments of some post-retirement benefit plans.

The Board believes that since SFAS 106 requires full current period recognition of curtailments, settlements, and termination benefits gains and losses, it is appropriate to accelerate the normal 15-year amortization period used for annual gains and losses to 10 years for any unrecognized curtailment, settlement, or special termination gain or loss.

If a plan is terminated, much of the unrecognized transition obligation and prior service cost, including any prior service cost from recent plan amendments and benefit improvements, will be eliminated by the coincident benefit curtailment, particularly the post-retirement benefit obligation attributable to nonvested benefits. Accordingly, unlike the pension Standard, the proposed Standard does not include a 60-month phase-in of plan amendments. Any remaining unamortized prior service cost and transition obligation would continue to serve as an inducement or compensation, albeit diminished, for future service.

18. Segment Closing Adjustment for Defined-Benefit Plans Using Accrual Accounting

*Comment:* Industry commenters expressed the view that the Government can protect its interests when a segment is closed through an adjustment similar to that found at paragraph 9904.413–50(c)(12). Industry commenters emphasized the Government's responsibility to share in any underfunding as well as in any surplus. The OUSD agreed that provisions similar to those found at paragraph 9904.413–50(c)(12) regarding pensions would be appropriate to address segment closings when the accrual accounting method had been employed.

*Response:* The proposed segment closing provisions are similar to the CAS 9904.413 segment closing provisions. This proposed Standard explicitly states that internal reorganizations do not constitute a segment closing. The proposed Standard measures an amount to be immediately recognized by an adjustment to contracts. However, this proposal provides that the contracting parties can determine the details on how the actual adjustment will be effected based upon the size of the adjustment and the contracting circumstances.

The Board proposes to measure the segment closing adjustment as the difference between the nonforfeitable post-retirement benefit obligation and the accumulated value of plan assets and unfunded accruals. These measures may result in either a credit or a charge to the Government. As previously discussed, the nonforfeitable post-retirement benefit obligation measures the firm or unavoidable liability.[11]

There has been some confusion about the CAS 9904.413 segment closing provisions when a segment is sold to a successor-in-interest and assets and liabilities are transferred from the seller to the buyer. The concept articulated in CAS 9904.413 and followed in this proposed Standard is that no adjustment is necessary to the extent that the contract cost accounting for the benefits

[11] The actuarial liability determined under the accrued benefit cost method which is used to determine the paragraph 9904.412–50(c)(12) segment closing for pensions is analogous to the nonforfeitable post-retirement benefit obligation in that it measures the firm liability for benefits earned by participants as of the date of the event (segment closing).

continues unaltered. This proposed Standard makes it clear that the contract cost accounting records used to determine the segment closing adjustment when there is a sale to a successor-in-interest are the same records that have been used up to the point of sale. The proposed Standard also describes how a segment's assets and liabilities shall be divided when part of the segment's liability is retained or the segment is otherwise split or merged as part of the sale, transfer, or other reorganization.

19. Segment Closing Under the Pay-as-You-Go Cost Method

*Comment:* Some industry respondents stated that regardless of whether the Cost Accounting Standards did or did not permit a contractor to use accrual accounting, the prior period post-retirement benefit costs were incurred to produce goods and services for the Government. They believed that any decision to not recognize the unfunded accumulated post-retirement benefit obligation would be a procurement allowability decision and not a cost accounting decision. Other industry commenters argued that the *Remington Arms* decision (Army Contract Adjustment Board (ACAB) Decision No. 1238 (1991)) made it clear that whenever the Government had benefitted from the contractor's use of the pay-as-you-go cost method in the past, the Government should bear responsibility for its share of the unfunded accumulated benefit obligation as a matter of equity and fairness. Texas Instruments did note that the *Remington Arms* case was based on the fact that the Government not only benefitted, but was complicit in the contractor's decision to use the pay-as-you-go cost method. SDP Technologies expanded the concept of complicity to include the Government's arguable influence on companies and segments that perform primarily Government work.

The *Remington Arms* case properly established the basic policy, *i.e.,* the Government has a special responsibility when it is the sole beneficiary of a company's operations. The responsibility is not limited to GOCO facilities but applies equally to situations where companies have been dedicated to supplying the Government, particularly under single source contracts where the Government has a substantial influence on which costs can be recovered.

In response to the Staff Discussion Paper issue on using a phase-in approach for Government responsibility for the unfunded post-retirement benefit obligation when a contractor had used the pay-as-you-go cost method in the past, the AIA made an argument for considering a phase-out of the Government's responsibility.

''In the near-term, a segment closing adjustment should apply to all situations. Industry's use of pay-as-you-go accounting has yielded considerable savings to the Government over the years; considering the unfunded amounts as an adjustment to previously determined postretirement benefit costs is highly appropriate, as it merely puts the Government in the same position it would have been in had accrual accounting been used in past years.''

* * * * *

''Over the long-run, however, there is a valid question as to whether or not contractors that account for their postretirement benefits cost on a pay-as-you-go basis should be entitled to a segment closing adjustment. By using pay-as-you-go accounting, these contractors will be relatively more competitive than other contractors that use accrual accounting (assuming that all else is equal, which is rarely true). Thus, the pay-as-you-go basis contractors might win contracts in the near-term due to their lower prices but might ultimately bill the same amount to the Government. This result hardly seems fair.

''To avoid this situation, the CAS Board could require contractors to make an election between pay-as-you-go accounting and accrual accounting with the explicit understanding that those contractors selecting pay-as-you-go accounting would not be able to claim a future segment closing adjustment. In this manner, decisions can be made by contractor management with a full understanding of the ultimate implications.''

Government respondents did not feel the Government should bear any responsibility for the unfunded accumulated post-retirement benefit obligation when the contractor had been using the pay-as-you-go cost method in the past. The DOD IG pointed out that ''the CASB–1 discloses the accounting practice under which the Government and contractor mutually agree to do business and the Government was not in any position to force the contractor to fund any PRBs.'' The OUSD commented that because Government regulations have permitted contractors to choose between accrual and cash basis accounting for such costs, the Government has no responsibility for the contractor's unilateral business decision.

*Response:* The segment closing adjustment measured under this proposal does not provide for the recognition of any accumulated post-retirement benefit obligation or nonforfeitable post-retirement benefit obligation for contractors that are required to use the pay-as-you-go cost method because their plan fails to meet the criteria for accrual accounting. For contractors that do use accrual accounting, this proposal measures the adjustment using the nonforfeitable post-retirement benefit obligation. While the contractor had the ability to use any appropriate accounting method, including accrual accounting, the general practice was to use the pay-as-you-go cost method prior to the adoption of SFAS 106. Once this proposed Standard becomes applicable, the contractor will be required to methodically assign and allocate the costs associated with its transition obligation to Government contracts for post-retirement benefit plans that meet the criteria for accrual accounting.

The Board understands that under the pay-as-you-go (cash basis accounting) cost method the Government may have received some benefit from lower contract costs in the past. However, the contractor may have benefitted from achieving a more competitive price by electing to use cash basis accounting. Furthermore, to impose the full responsibility on the Government for costs not accrued under cost-based contracts ignores the fact that both contractors and the accounting profession at large were content to use the pay-as-you-go cost method in the past.

The Board finds no accounting justification for imposing a current period cost adjustment which arises from the contractor's previous decision to use cash basis accounting or terminal funding. The Board does note that a legal question, not an accounting question, of equity may be involved in the very special situation of GOCO facilities, such as that addressed in the *Remington Arms* decision, where the Government was found to be involved in the selection of the accounting method.

20. Determination of the Government's Share of the Segment Closing Adjustment

*Comment:* In its comments, the NDIA discusses how extraordinary events and segment closings require recognition in the financial results of operations for an accounting period and how the same type of adjustments might be appropriate for Government contract cost accounting purposes. The ABA agreed that a segment closing adjustment would be appropriate but expressed concern about how the Government's share is determined and effected when they wrote:

* * * In our earlier submission we counseled against reopening the prices of fixed price type contracts, or cost type contracts in years that are closed. Limiting the adjustment mechanism to costs only is consistent with sound procurement policy

and will secure to the government and the contractor equally the benefit of their bargain. Moreover, the OFPP Act Amendments of 1988 do not provide the CAS Board with authority to adjust contract prices, other than the equitable adjustment mechanism for cost accounting practice changes or noncompliances that result in increased costs to the government. *See* Public Law 100–679, section 26(h)(1), 41 U.S.C. 422(h)(1). For this reason, we believe that CAS 413–50(c)(12), as amended March 30, 1995, is subject to challenge as exceeding the Board's statutory authority

*Response:* The Board proposes that this Standard, like CAS 9904.413, consider all prior cost-based contracts that become subject to this proposed Standard when determining the Government's share of any over-or under-funding of the past post-retirement benefit costs. The proposed Standard does not reopen any contracts nor adjust any prior period costs, but instead captures the Government's share of the gain or loss amounts that would have been excluded from or included in the prior period cost accruals used to price contracts had the segment closing been anticipated.

The Board notes that in addition to paragraph 9904.413–50(c)(12) regarding pensions, the original Board recognized the need for exceptional accounting treatment when an usually large or non-routine depreciation gain or loss occurs. Paragraph 9904.409–50(j)(3) provides:

> The contracting parties may account for gains and losses arising from mass or extraordinary dispositions in a manner which will result in treatment equitable to all parties.

*F. Additional Public Comments*

Interested persons are invited to participate by submitting data, views or arguments with respect to this ANPRM. All comments must be in writing and submitted to the address indicated in the **ADDRESSES** section.

When reviewing this proposed Cost Accounting Standard, the Board asks that respondents consider and provide comments regarding the questions discussed below. When responding, commenters are asked to discuss the basis for their conclusions.

1. Definition of Nonforfeitable

The Board notes that under many post-retirement benefit plans, employees are often not granted a vested right to post-retirement benefits until they attain retirement or full eligibility age. The proposed definition of the term ''nonforfeitable,'' similar to that in the pension Standard, includes an exception for benefits forfeited because an employee terminates employment prior to attaining eligibility for benefits. Given the extended delay in attaining eligibility rights to a post-retirement benefit under most plans, the Board is interested in any comments regarding the appropriateness of this exception for post-retirement benefit costs.

2. Recognition of Post-Retirement Benefit Costs

(a) *Alternative or additional criteria for determining what creates a firm liability:* As discussed in subsection F.3, the Board believes that the SFAS 106 recognition of the obligation for the ''substantive plan'' is inappropriate for Government contract cost accounting. In fact, the Board has included a limitation on the annual cost accrual because of its concern that the existence of a written description of the plan which is communicated to the plan participants may not ensure that there is a contractual and enforceable, that is, compellable, obligation to pay the promised benefits. The Board is interested in any alternative or additional criteria that might serve to ascertain the firmness of the post-retirement benefit liability.

(b) *Firmness of the liability and the role of funding:* The Board realizes that many contractors will desire to retain the right to terminate their post-retirement benefit plan or take other actions to reduce or eliminate benefits attributable to prior service. While acknowledging the limitation of tax-advantaged funding vehicles for retiree health benefits, the Board asks respondents to this proposed Standard to consider whether funding could provide an appropriate and effective alternative or whether additional criteria should be considered.

3. Measurement and Assignment of Post-Retirement Benefit Costs

(a) *Actuarial assumptions:* The Board remains concerned that the volatility of health care trends, coupled with the SFAS 106 emphasis on current market conditions, could create an unacceptable degree of uncertainty in the estimates of the liability for future post-retirement benefits, especially for retiree health care benefits. This volatility or uncertainty could adversely affect the forward pricing process which relies on CAS compliant cost data. The Board invites further comments regarding whether actuarial assumptions used for contract costing purposes should each be based on ''best-estimate,'' long-term expectations rather than relying on the SFAS 106 guidance. The Board also asks that contractors, actuaries, or Government officials submit any historical data they may have regarding the volatility of post-retirement benefit costs.

(b) *Reporting on sources of annual gains and losses:* As discussed under subsections F.12 and F.13, greater visibility of cost measurements may be obtained by requiring that annual gains and losses be reported by source, that is, separate identification of gains and losses from asset performance, population and demographic changes, assumption changes, and cost method changes. The Board asks for comments on whether visibility and oversight would be enhanced by a disclosure of each such portion of the annual gain or loss.

(c) *Amortization of gains and losses:* The Board notes that the proposed rule requires full recognition of gains and losses on an amortized basis. This differs from SFAS 106 which requires amortization of cumulative gains and losses that exceed a corridor of the greater of 10% of the projected post-retirement benefit obligation or the fair value of assets. SFAS 106 does permit full recognition of gains and losses on an amortized basis. This proposed provision is intended to keep cost recognition more closely associated with the accounting period in which the gain or loss occurred. The Board would be interested in views regarding the use of the SFAS 106 amortization corridor for Government contract costing purposes.

(d) *Limiting medical inflation assumption:* The Board seeks comments concerning whether a limit should be placed on the health care trend rate. Commenters are asked to consider what limit, *e.g.,* the long-term expected rate of return, the Treasury rate, is appropriate for Government contract costing purposes. The Board is also interested in any information concerning the degree of volatility and uncertainty in the medical inflation assumption.

(e) *Terminal funding method:* Notwithstanding the Board's response in E.6 that terminal funding is an unacceptable cost method under GAAP, the Board would like comments regarding how prevalent the use of the terminal funding method is among contractors. Commenters should also address whether a contractor should be permitted to elect to use the terminal funding method either at the time this proposed rule would first be applicable or even be permitted to later elect to use the terminal funding method.

(f) *Amortization of lump sum settlements and single premium payments:* For plans accounted for under the pay-as-you-go cost method, the proposed Standard is consistent with subparagraph 9904.412–

40(b)(3)(iii) and paragraph 9904.412–50(b)(1). The proposed Standard requires that when a portion of the liability is liquidated prior to the periods in which benefit payments are expected to occur, such lump sum settlement or single premium payment shall be amortized. The Board further notes that such amortization is consistent with paragraph 52 of SFAS 106 requiring that costs of plans primarily attributable to retirees shall be attributed to the future life-expectancy of the retirees. Commenters are asked to provide any rationale for recognizing these single period settlements on an immediate basis rather than an amortized basis, especially if the contractor has not been using terminal funding for its post-retirement benefit plan.

(g) *Long-term expected rate of return:* The Board favored using the interest rate as determined by the Secretary of the Treasury pursuant to Public Law 92–41, 85 Stat. 97. to measure the interest equivalent on the accumulated value of unfunded accruals and accumulated value of prepayment credits. The Board is interested in comments regarding the appropriateness of the Treasury rate and whether commenters believe some other rate may be more appropriate.

4. Allocation of Post-Retirement Benefit Costs to Segments

(a) *Criteria for separate calculation of post-retirement benefit costs:* This proposal includes similar criteria to that found in CAS 9904.413 for determining when separate calculations are necessary. The Board seeks comments regarding whether there are additional conditions or events that may materially affect the determination of post-retirement benefit costs at the segment level which should require a separate calculation of post-retirement benefit costs for a segment.

(b) *Separate calculation as the only measurement for segment costs:* Because of the availability of computers and the availability of sophisticated actuarial valuation software, requiring separately calculated costs by segment no longer imposes the administrative burden that it would have in 1977. The Board asks for comments regarding a requirement that costs always be separately calculated for segments unless it can be reasonably demonstrated that a general allocation would provide materially similar results.

5. Allocation to Intermediate and Final Cost Objectives

Because the determination of certain adjustments will require an assessment of the Government's historical participation in post-retirement benefit costs, the Board considered including a record-keeping requirement regarding allocations of post-retirement benefit costs to contracts subject to this Standard. The Board is interested in whether contractor or Government representatives have experience or concerns about the necessary data being readily available regarding the Government's historical participation absent such a requirement.

6. Adjustments for Curtailments, Settlements, and Special Termination Benefits

The Board would appreciate any comments regarding any alternatives to the proposed ten-year amortization period that should be considered.

7. Adjustments for Segment Closings

(a) *Government's responsibility for future salary increases and health care trends:* The preamble to the March 30, 1995 amendments to CAS 9904.413 noted that existing and past Government contracts of the closed segment neither cause nor benefit from future salary increases. The Board is interested in any comments regarding whether the effect of such future salary levels should be excluded from the determination of a segment closing adjustment for post-retirement benefit costs.

(b) *Previous use of the pay-as-you-go cost method:* As proposed, this Standard would provide for the recognition of the unfunded nonforfeitable post-retirement benefit obligation for contractors using accrual accounting that had been using the pay-as-you-go cost method before this Standard was applicable. The Board seeks any comments regarding whether there should be a phase-in of such recognition.

(c) *''Homeless'' inactives retained by a seller:* After a segment is sold, the seller may retain ''inactive'' plan participants that were formerly associated with the sold segment. Consequently, the seller (transferor) can no longer allocate accrued post-retirement benefit costs generated by these inactive participants to the sold segment for allocation to that segment's intermediate and final cost objectives. Accordingly, the Board considered allocating the assets to the inactive participants retained by the seller (transferor) before any assets are allocated to the active participants who go to the buyer (transferee). The Board is interested if there is any rationale for giving inactive participants such preferential funding when a segment is sold or ownership is otherwise transferred.

(d) *Recognition of retained liability:* The Board is aware that some hold the belief that when a segment is sold or ownership is otherwise transferred, the selling price or transfer agreement explicitly or implicitly reflects compensation to the seller for any future post-retirement benefit obligations retained by the seller. Conversely, the belief holds that there is an implicit credit to the buyer for any post-retirement benefit obligations assumed by the buyer. Based on this belief, it has been suggested that Government contractors utilizing the pay-as-you-go method to account for post-retirement benefit costs should separately identify any retained participants of the disposed segment. In such cases, the post-retirement benefit payments made for these inactive participants would not be included/recognized, after the sale or transfer, as allocable costs with respect to the seller's ongoing cost-based Government contracts.

The Board has not included such a provision in the Standard being proposed today, but is interested in any data or information that commenters can provide on alternative treatments of the liability and future payments for retained participants, for Government contract costing purposes in connection with a sale or ownership transfer.

8. Illustrations

The Board is interested in comments regarding whether displaying the accumulated post-retirement benefit obligation routinely as a debit, except when illustrating SFAS 106 disclosures, creates confusion.

**List of Subjects in 48 CFR 9904**

Government Procurement, Cost Accounting Standards.

**Richard C. Loeb,**

*Executive Secretary, Cost Accounting Standards Board.*

It is proposed to amend part 9904 as follows:

## PART 9904—COST ACCOUNTING STANDARDS

1. The authority citation for Part 9904 continues to read as follows:

**Authority:** Public Law 100–679, 102 Stat 4056, 41 U.S.C. 422.

2. Section 9904.416–50 is amended by revising paragraph (*a*)(*1*)(*v*) to read as follows:

**9904.416–50 Techniques for application.**

(a) * * *

(1) * * *

(v) If an objective of an insurance program is to provide insurance

coverage on retired persons, then such program is subject to Cost Accounting Standard 9904.419 except as provided in 9904.419–40(b)(2).

* * * * *

**9904.416–60 [Amended]**

3. Section 9904.416–60 is amended by removing and reserving paragraphs (c), (d) and (e).

4. Sections 9904.419, 9904.419–20, 9904.419–30, 9904.419–40, 9904.419–50, 9904.419–60, 9904.419–62, 9904.419–63, 9904.419–64 are added to read as set forth below.

5. Section 9904.419–10 and 9904.419–61 are added and reserved to read as follows:

**9904.419 Cost accounting standard for measurement, assignment, allocation, and adjustment of post-retirement benefit cost.**

**9904.419–10 [Reserved]**

**9904.419–20 Purpose.**

(a) The purpose of this Standard is to provide criteria for measuring the costs of post-retirement benefit plans, assigning the measured costs to cost accounting periods, and allocating the assigned costs to segments of an organization. This Standard also provides the basis on which segments shall allocate assigned post-retirement benefit costs to their intermediate and final cost objectives. The provisions of this Cost Accounting Standard should enhance uniformity and consistency in accounting for post-retirement benefit costs and thereby increase the probability that those costs are allocated to segments and to cost objectives within segments in a uniform and consistent manner.

(b) This Standard provides for the adjustment of post-retirement benefit costs for the effect of a curtailment of a post-retirement benefit plan, a settlement of a post-retirement benefit obligation, a granting of termination benefits, a termination of a post-retirement benefit plan, or a segment closing.

(c) This Standard is applicable to the cost of all post-retirement benefit plans except for costs of pension plans and deferred compensation which are covered in other Cost Accounting Standards.

**9904.419–30 Definitions.**

(a) The following are definitions of terms which are prominent in this Standard. Other terms defined elsewhere in this chapter 99 shall have the meaning ascribed to them in those definitions unless paragraph (b) or (c) of this subsection requires otherwise.

(1) *Accumulated value of unfunded accruals* means the value, as of the measurement date, of post-retirement benefit costs that have been accrued but not funded, adjusted for imputed earnings and for benefits paid by the contractor.

(2) *Business unit* means any segment of an organization, or an entire business organization which is not divided into segments.

(3) *Captive insurer* means an insurance company that does business primarily with related entities. Related entities include, but are not limited to, companies that are owned by or under the control of the contractor, including affiliates, parents, subsidiaries, or controlling entities.

(4) *Fair value* means the amount that a plan could reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale.

(5) *Funded post-retirement benefit cost* means the portion of post-retirement benefit cost for a current or prior cost accounting period that has been paid to a funding agency.

(6) *Market-related value of plan assets* means a balance used to calculate the expected return on plan assets. Market-related value can be either fair value or a calculated value that recognizes changes in fair value in a systematic and rational manner over not more than five years. Different methods of calculating market-related value may be used for different classes of plan assets, but the manner of determining market-related value shall be applied consistently from year to year for each class of plan asset.

(7) *Nonforfeitable post-retirement benefit obligation* means the accumulated post-retirement benefit obligation for benefits, or that portion of benefits, for which the participant's eligibility to receive a present or future post-retirement benefit is no longer contingent on remaining in the service of the employer or attaining a specified age. The excess, if any, of the nonforfeitable post-retirement benefit obligation, including benefit eligibility as of the last day of the plan year, over the valuation assets is the unfunded nonforfeitable post-retirement benefit obligation. Any accumulated post-retirement benefit obligation in excess of the nonforfeitable post-retirement benefit obligation is the forfeitable post-retirement benefit obligation.

(8) *Pension plan* means a deferred compensation plan established and maintained by one or more employers to provide systematically for the payment of benefits to plan participants after their retirement, provided that the benefits are paid for life or are payable for life at the option of the employees. Additional benefits such as permanent and total disability and death payments, and survivorship payments to beneficiaries of deceased employees may be an integral part of a pension plan.

(9) *Post-retirement benefit plan* means an arrangement that is mutually understood by an employer and its employees, whereby an employer undertakes to provide its employees with post-retirement benefits after they retire in exchange for their services over a specified period of time, upon attaining a specified age while in service, or a combination of both. A post-retirement benefit plan may be written or it may be implied by a well-defined, although perhaps unwritten, practice of paying post-retirement benefits or by oral representations made to current or former employees.

(10) *Post-retirement benefit plan participant* means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit from a post-retirement benefit plan which covers employees of such employer or members of such organization who have satisfied the plan's participation requirements, or whose beneficiaries are receiving or may be eligible to receive any such benefit. A participant whose employment status with the employer has not been terminated is an active post-retirement benefit plan participant.

(11) *Post-retirement benefit plan termination* means an event in which the post-retirement benefit plan ceases to exist and all benefits are settled by the purchase of insurance contracts or by other means. The plan may or may not be replaced by another plan.

(12) *Post-retirement benefits* means all forms of benefits, other than retirement income, provided by an employer to retirees. Those benefits may be defined in terms of specified benefits, such as health care, tuition assistance, or legal services, that are provided to retirees as the need for those benefits arises, such as certain health care benefits, or they may be defined in terms of monetary amounts that become payable on the occurrence of a specified event, such as life insurance benefits not provided through a pension plan. Benefits provided in whole or in part by funds that are separately accounted for within the trust fund of a qualified pension plan shall be considered post-retirement benefits subject to this Standard.

(13) *Segment* means one of two or more divisions, product departments, plants, or other subdivisions of an organization reporting directly to a home office, usually identified with responsibility for profit and/or

producing a product or service. The term includes Government-owned contractor-operated (GOCO) facilities, and joint ventures and subsidiaries (domestic and foreign) in which the organization has a majority ownership. The term also includes those joint ventures and subsidiaries (domestic and foreign) in which the organization has less than a majority ownership, but over which it exercises control.

(14) *Successor-in-interest* means an entity that assumes all obligations under the government contract or contracts of a contractor through a novation agreement. A novation agreement is one that is executed by a contractor (transferor), a successor-in-interest (transferee), and the Government, by which the transferor guarantees performance of the contract, the transferee assumes all obligations under the contract, and the Government recognizes the transfer of the contract and related assets.

(15) *Unfunded accumulated post-retirement benefit obligation* means the accumulated post-retirement benefit obligation in excess of the valuation assets. The excess of the valuation assets over the accumulated post-retirement benefit obligation is an actuarial post-retirement benefit surplus and is treated as a negative unfunded accumulated post-retirement benefit obligation.

(16) *Valuation assets* means the total value of assets used to determine post-retirement benefit cost. Valuation assets are the sum of the fair value of assets plus the accumulated value of unfunded accruals reduced by the accumulated value of prepayment credits.

(b) The following modifications of terms defined elsewhere in this Chapter 99 are applicable to this Standard:

(1) *Actuarial cost method* means a technique which uses assumptions to measure the present value of future post-retirement benefits and post-retirement benefit plan administrative expenses, and which assigns the cost of such benefits and expenses to cost accounting periods. The actuarial cost method includes the asset valuation method used to determine the market-related value of plan assets.

(2) *Funding agency* means an organization or individual which provides facilities to receive and accumulate assets to be used either for the payment of benefits under a post-retirement benefit plan, or for the purchase of such benefits, provided such accumulated assets form a part of a post-retirement benefit plan established for the exclusive benefit of the plan participants and their beneficiaries.

(3) *Nonforfeitable* means a right to a post-retirement benefit, either immediate or deferred, which arises from an employee's service, which is unconditional, and which is legally enforceable against the post-retirement benefit plan or the contractor. Rights to benefits that do not satisfy this definition are considered forfeitable. A right to a post-retirement benefit is not considered forfeitable solely because it may be affected by the employee's or beneficiary's death or disability. Nor is a right considered forfeitable because it can be affected by the unilateral actions of the employee.

(4) *Pay-as-you-go cost method* means a method of recognizing post-retirement benefit cost only when post-retirement benefits are paid to or on behalf of retired employees or their beneficiaries.

(5) *Prepayment credit* means the amount funded in excess of the post-retirement benefit cost assigned to a cost accounting period that is carried forward for future recognition.

(ii) *The accumulated value of prepayment credits* means the value, as of the measurement date, of the prepayment credits adjusted for imputed earnings and decreased for amounts used to fund post-retirement benefit costs or obligations, whether assignable or not.

(6) *Segment closing* means that a segment or business unit has been sold or ownership has been otherwise transferred, discontinued operations, or discontinued doing or actively seeking Government business under contracts subject to this Standard. Segment mergers or splits within the contractor's operations shall not be considered a segment closing for purposes of this Standard.

(c) Other terms used prominently in this Standard have the same meanings as in Statement of Financial Accounting Standards No. 106 ''Employers'' Accounting for Post-retirement Benefits Other Than Pensions' (SFAS 106), including subsequent amendments.

**9904.419–40 Fundamental requirements.**

(a) *Recognition of post-retirement benefit costs.* The commitment to provide post-retirement benefits in future periods shall be evidenced by a post-retirement benefit plan.

(1) The cost of a post-retirement benefit plan shall be accounted for using accrual accounting provided that:

(i) The right to a post-retirement benefit is communicated in writing to the participants, including notice of the right to legally enforce payment of such benefit.

(ii) The participant has an irrevocable right to any portion of a benefit for which the participant has attained eligibility.

(iii) If the contractor reserves rights to terminate or otherwise cancel, eliminate, or reduce the rights of employees to any portion of post-retirement benefits for which an employee has become eligible, the post-retirement benefit plan shall fail to meet the criteria set forth in paragraph (a)(1)(ii) of this section.

(iv) For defined-contribution post-retirement plans, the cost for a cost accounting period is the contribution required by the written provisions of the post-retirement benefit plan.

(v) For defined-benefit post-retirement plans, the cost for a cost accounting period is actuarially determined based upon the written provisions of the post-retirement benefit plan.

(2) The cost of any post-retirement benefit plan that fails to meet the criteria set forth in 9904.419–40(a)(1) shall be accounted for using the pay-as-you-go cost method.

(b) *Measurement and assignment of post-retirement benefit cost.*

(1) Except for costs assigned to future periods by 9904.419–40(b)(5)(iii), the amount of post-retirement benefit cost determined for a cost accounting period is assignable only to that period.

(2) To the extent that insurance contracts are purchased during the period to cover post-retirement benefits attributed to service in the current period:

(i) The cost of those benefits shall be accounted for in accordance with Cost Accounting Standard 9904.416, Accounting for Insurance Costs.

(ii) However, if the insurance is purchased from a captive insurer, the post-retirement benefit cost shall be determined in accordance with this Standard.

(iii) The costs of benefits attributed to current service in excess of benefits provided by such insurance contracts purchased during the current period shall be accounted for according to the provisions of this Standard applicable to plans not involving insurance contracts.

(iv) For purposes of 9904.419–40(b)(3)(ii) and 9904.419–50(e)(2)(i), the cost of purchasing contracts to irrevocably settle all obligations for post-retirement benefit obligations to a plan participant or participants shall be treated the same as any other settlement payment.

(3) For plans accounted for under the pay-as-you-go cost method, the components of post-retirement benefit cost for a cost accounting period are the contractor's share of:

(i) The net amount paid to or on behalf of retired employees or their

beneficiaries for post-retirement benefits incurred during that period, and

(ii) An amortization installment, including an interest equivalent on the unamortized settlement amount, attributable to the net amount paid to irrevocably settle an obligation for post-retirement benefits of current and future cost accounting periods.

(4) For defined-contribution plans using accrual accounting, the post-retirement benefit cost for a cost accounting period is the net contribution required to be made to participants' accounts for that period, after taking into account dividends and other credits, where applicable.

(5) For defined-benefit plans using accrual accounting:

(i) The components of post-retirement benefit cost for a cost accounting period are:

(A) Service cost,

(B) Interest cost,

(C) Actual return on the fair value of plan assets, adjusted for interest equivalents on the accumulated value of unfunded accruals or prepayment credits,

(D) Amortization of unrecognized prior service cost, if any,

(E) The amortization of the unrecognized gain or loss as provided for in this Standard, and

(F) Amortization of any unrecognized transition obligation or asset.

(ii) The post-retirement benefit cost of a cost accounting period shall be determined by use of the same methods, assumptions, and asset values used for financial reporting purposes in accordance with SFAS 106, as amended, unless specified otherwise in this Standard.

(iii) The post-retirement benefit costs assigned to a period shall not exceed the assignable post-retirement benefit cost limitation. Any amount in excess of the assignable post-retirement benefit cost limitation shall be recognized in future periods as an actuarial loss in accordance with 9904.419–50(b)(2)(vii). The assignable post-retirement benefit cost limitation is measured as the sum of:

(A) The amount of benefits paid by the contractor for the cost accounting period, and,

(B) The unfunded nonforfeitable post-retirement benefit obligation, if any.

(iv) The post-retirement benefit cost of a cost accounting period is assignable only if the unfunded accumulated post-retirement benefit obligation equals the sum of the unrecognized net gain or loss (including any unrecognized amount determined in accordance with 9904.419–50(e)(2)(i)), unrecognized prior service cost, and the unrecognized transition obligation or transition asset.

(c) *Post-retirement benefit cost of segments.*

(1) Post-retirement benefit costs shall be directly or indirectly allocated to each segment having participants identified with the post-retirement benefit plan who generate cost under the cost accounting method in use. If a post-retirement benefit plan has plan participants in a home office, the home office shall be treated as a segment for purposes of allocating the cost of the post-retirement benefit plan.

(2) A separate calculation (direct allocation) of post-retirement benefit costs for a segment is required when any of the conditions set forth in 9904.419–50(c)(2) is present. When such conditions are not present, indirect allocations may be made by calculating a composite post-retirement benefit cost for two or more segments and allocating this cost to these segments.

(3) For defined-benefit plans using accrual accounting:

(i) Except where use of a different assumption or assumptions is required by 9904.419–50(c)(2)(iii), the same assumptions shall be used for all segments covered by a plan.

(ii) Contractors shall separately account for the assets and accumulated value of unfunded accruals of each segment whenever post-retirement benefit costs are separately calculated for the segment.

(d) *Allocation of post-retirement benefit cost to cost objectives.* The post-retirement benefit costs for a segment are allocable to that segment's intermediate and final cost objectives.

(e) *Adjustments for curtailments, settlements, and termination benefits.* In the event that a contractor curtails a post-retirement benefit plan, settles a post-retirement benefit obligation, or grants termination benefits:

(1) For plans accounted for under the pay-as-you-go cost method, no adjustment attributable to previously determined post-retirement benefit costs is permitted to be recorded. Existing contract prices or costs shall not be adjusted.

(2) For defined-contribution plans using accrual accounting, if the post-retirement benefit plan is terminated or the right to earn future vesting or retirement eligibility service is curtailed, the contractor must separately determine the financial effect of such event and record an adjustment for each affected segment. The adjustment shall be amortized over the current and future periods. Existing contract prices or costs shall not be adjusted.

(3) For defined-benefit plans using accrual accounting, the contractor must separately recognize the financial effect of such event by recording an adjustment for each affected segment. The adjustment shall be amortized over the current and future periods. Existing contract prices or costs shall not be adjusted.

(f) *Adjustments for segment closings.* If a segment is closed, the contractor shall determine the effect of such segment closing on the post-retirement benefit costs of each affected segment.

(1) For plans accounted for under the pay-as-you-go cost method, no segment closing adjustment attributable to previously determined post-retirement benefit costs is permitted.

(2) For defined-contribution plans using accrual accounting, the contractor shall determine a segment closing amount which represents an adjustment to previously determined post-retirement benefit costs that were recognized as incurred costs at the closed segment. The recorded amount shall give full recognition to any unrecognized portion of any credit for plan termination or curtailment of vesting or retirement eligibility service. Recovery or payment of the Government's share of such amount shall be made as an adjustment to contract price or cost or by other suitable techniques.

(3) For defined-benefit plans using accrual accounting, the contractor shall determine a segment closing amount which represents an adjustment to previously determined post-retirement benefit costs that were recognized as incurred costs at the closed segment. The recorded amount shall give full recognition to the nonforfeitable post-retirement benefit obligation and valuations assets, except to the extent the nonforfeitable post-retirement benefit obligation and valuations assets have been assumed by a successor-in-interest to the contracts of the closed segment. To the extent that the accumulated post-retirement benefit obligation, nonforfeitable post-retirement benefit obligation, valuations assets and associated unrecognized amounts have been so transferred, the effect of such transfer will be recognized in future accounting periods by the successor-in-interest. Recovery or payment of the Government's share of the segment closing amount shall be made as an adjustment to contract price or cost or by other suitable techniques.

**9904.419–50 Techniques for Application.**

(a) *Recognition of post-retirement benefit costs.*

(1) Post-retirement benefit costs shall be determined separately for each post-retirement benefit plan by applying the provisions of this Standard to each such plan. Post-retirement benefit costs may be determined on an aggregate basis for two or more separate plans if those plans use the same cost accounting method, that is, accrual accounting or the pay-as-you-go method, and either:

(i) Those plans provide different benefits to the same group of plan participants, or

(ii) Those plans provide benefits that are similar in definition and amount to different groups of plan participants.

(2) If a post-retirement benefit plan provides two or more separately identifiable categories of benefits, *e.g.,* healthcare benefits and life insurance benefits, the contractor may treat each benefit as a separately identifiable post-retirement benefit plan. The costs of each such post-retirement benefit plan may be separately determined and accounted for.

(3) If a post-retirement benefit plan provides benefits to two or more mutually exclusive classes of plan participants, *e.g.,* those eligible for retirement before a specified date and those eligible after such date, the contractor may treat each such mutually exclusive class as a separately identifiable post-retirement benefit plan. The costs of post-retirement benefit plan may be separately determined and accounted for.

(4) If the substance of a post-retirement benefit plan having characteristics of both a defined-benefit post-retirement plan and a defined-contribution post-retirement plan is to provide a defined benefit, the costs of such plan shall be determined and accounted for in accordance with the provisions of this Standard applicable to defined-benefit post-retirement plans. Conversely, if the substance of a post-retirement benefit plan having characteristics of both a defined-benefit plan and a defined-contribution plan is to provide benefits determined by defined contributions, the costs of such plan shall be determined and accounted for in accordance with the provisions of this Standard applicable to defined-contribution post-retirement plans.

(5) A multiemployer post-retirement benefit plan established pursuant to the terms of a collective bargaining agreement shall be considered to be a defined-contribution post-retirement plan for purposes of this Standard.

(6) A post-retirement benefit plan applicable to a Federally-funded Research and Development Center (FFRDC) that is part of a State post-retirement benefit plan shall be considered to be a defined-contribution post-retirement plan for purposes of this Standard.

(7) Post-retirement benefits provided in whole or in part by funds that are separately accounted for within the trust fund of a qualified pension plan shall be accounted for as post-retirement benefits subject to this Standard.

(b) *Measurement and assignment of post-retirement benefit cost.*

(1) For plans accounted for under the pay-as-you-go cost method, any amount paid to irrevocably settle an obligation for post-retirement benefits payable in current and future cost accounting periods shall be amortized over a period of fifteen years in equal annual installments. Such amortization shall include an interest equivalent each period equal to the rate determined by the Secretary of the Treasury pursuant to Public Law 92–41, 85 Stat. 97 at the time of the settlement. If the amount paid to settle the obligation is not material, the full amount of the settlement may be assigned to the current period.

(2) For plans using accrual accounting:

(i) Post-retirement benefit cost shall be determined based on current active and inactive plan participants. This provision shall not preclude use of an assumption concerning future reemployments.

(ii) Post-retirement benefit cost shall be determined based on the written provisions of the post-retirement benefit plan. This shall not preclude contractors from making salary projections for plans whose benefits are based on salaries and wages, nor from considering benefit revisions for plans which provide that such revisions must be made.

(iii) The assumed health care trend rate may not exceed the assumed expected long-term rate of return on plan assets. If no assumption is made concerning the expected long-term rate of return on plan assets, the health care trend rate assumption shall not exceed the interest rate as determined by the Secretary of the Treasury pursuant to Public Law 92–41, 85 Stat. 97.

(iv) The actual return on the fair value of plan assets component of post-retirement benefit cost shall be increased by an interest equivalent on the accumulated value of unfunded accruals determined using the interest rate as determined by the Secretary of the Treasury pursuant to Public Law 92–41, 85 Stat. 97.

(v) The actual return on the fair value of plan assets component of post-retirement benefit cost shall be decreased by an interest equivalent on the accumulated value of prepayment credits determined using the interest rate as determined by the Secretary of the Treasury pursuant to Public Law 92–41, 85 Stat. 97.

(vi) The fair value and market-related value of plan assets shall not be adjusted for any fee, reserve charge, or other investment charge for withdrawals from or termination of an investment or insurance contract, trust agreement, or other funding arrangement, unless such fee is determined in an arm's length transaction, and actually is incurred and paid.

(vii) The gain or loss component of post-retirement benefit cost (excluding plan asset gains and losses not yet reflected in the market-related value of plan assets) that is determined for a cost accounting period shall be recognized as follows:

(A) The contractor shall amortize each gain or loss over the average remaining service period of active plan participants. If all or almost all of a plan's participants are inactive, the average remaining life expectancy of the inactive participants shall be used instead of the average remaining service period. If the gain or loss is not material, the entire gain or loss may be included as a component of the current or ensuing period's post-retirement benefit cost.

(B) Except as provided in 9904.419–50(e)(2)(i), the contractor shall establish and consistently follow a policy for amortizing gains and losses. Any amortization policy shall include criteria for selecting specific amortization periods and may give consideration to factors such as the size and nature of the gain or loss. Once the amortization period for a gain or loss is selected, the amortization process shall continue to completion unless full recognition is required by 9904.419–50(f)(3)(i).

(viii) Any tax assessed pursuant to a law or regulation because of excess, inadequate, or delayed funding of a post-retirement benefit plan shall be excluded from the assigned post-retirement benefit cost and from the tax expense reflected in the actual return on the fair value of plan assets component of post-retirement benefit costs.

(c) *Post-retirement benefit cost of segments.*

(1) Contractors who calculate a composite post-retirement benefit cost covering plan participants in two or more segments shall allocate such composite costs to segments as follows:

(i) For plans accounted for under the pay-as-you-go cost method, the contractor shall allocate post-retirement benefit costs to a segment to the extent that such costs can be identified with

that segment. Any post-retirement benefit costs remaining after such allocation shall be categorized as a residual expense of the home office or home offices most immediately identified with the post-retirement benefit plan. The allocation of post-retirement benefit costs shall give consideration to any refund, rebate, or other credit, that is disproportionately attributable to individual segments.

(ii) For plans using accrual accounting, contractors shall indirectly allocate or separately calculate post-retirement benefit costs for each segment having active or inactive participants of the post-retirement benefit plan. Any allocation base selected shall be representative of the factors used to calculate the post-retirement benefit cost, such as headcount or salary.

(2) For plans using accrual accounting, post-retirement benefit costs shall be separately calculated for a segment (including an aggregation of segments) whenever any of the following conditions exist for that segment, provided that such condition(s) materially affect the amount of post-retirement benefit cost allocated to the segment:

(i) The cost of benefits, level of benefits, eligibility for benefits, or plan demographics are materially different for the segment than for the average of all segments; or

(ii) There is a refund, credit, or other gain or loss from one or more sources that is disproportionately attributable to the segment. If such refund, credit, gain or loss is expected to be non-recurring, separate calculations are not required unless required by other conditions of this paragraph. In that case, there shall be a special direct allocation of only the non-recurring amount which shall be accounted for and amortized at the segment level.

(iii) For defined-benefit plans, any appropriate assumption or assumptions are materially different for the segment than for the average of all segments.

(iv) For defined-benefit plans, a contractor follows a practice of funding post-retirement benefit costs disproportionately for segments subject to this Standard.

(v) For defined-benefit plans,

(A) If the post-retirement benefit plan for a segment becomes merged with the plan of another segment, or the post-retirement benefit plan is divided into two or more post-retirement benefit plans, and in either case,

(B) The ratios of valuation assets to the accumulated post-retirement benefit obligation for each of the merged or separated plans are materially different from one another after applying the benefits in effect after the post-retirement benefit plan merger or post-retirement benefit plan division.

(3) For plans using accrual accounting, notwithstanding the provisions of paragraph (c)(2) of this subsection, contractors may elect to calculate post-retirement benefit costs separately for each segment having participants in a post-retirement benefit plan.

(4) For segments whose post-retirement benefit costs are calculated separately pursuant to paragraphs (c)(2) or (3) of this subsection, such calculations shall be prospective only; post-retirement benefit costs shall not be redetermined for prior years.

(5) Funding of post-retirement benefit cost for a cost accounting period shall be considered to have taken place within such period if it is accomplished by the corporate tax filing date for such period, including any permissible extensions thereto.

(6) For defined-benefit plans using accrual accounting, whenever pension cost for a segment is calculated separately pursuant to paragraphs (c)(2) or (3) of this subsection:

(i) When post-retirement benefit costs are first separately calculated for a segment, there shall be an initial allocation of a share in the undivided fair value of plan assets and the undivided accumulated value of unfunded accruals to segments. This division shall be made in accordance with 9904.419–50(c)(6)(viii) based upon the nonforfeitable post-retirement benefit obligation and nonforfeitable post-retirement benefit obligation, except as otherwise provided for in this subparagraph. Prior to this initial allocation of assets, the accumulated value of prepayment credits, if any, shall be deducted from the undivided fair value of plan assets and separately identified.

(A) If a contractor has separately identified the fair value of plan assets in accordance with 9904.419–64(f), such fair value of plan assets and all other values previously allocated to those segments as of the date of such determination shall not be changed.

(B) If a contractor has been determining the accrual for post-retirement benefit costs on a composite basis and allocating such costs to segments, the initial allocation of the valuation assets shall reflect such prior cost determinations and allocations made pursuant to this Standard. If the necessary data are readily determinable, the fair value of plan assets to be allocated to each segment shall be the amount contributed by, or on behalf of, the segment, increased by income received on such assets, and decreased by benefits and expenses paid from such assets.

(C) If the necessary data are not readily determinable for certain prior periods, the fair value of plan assets net of any separately identified accumulated value of prepayment credits shall be allocated to segments based on the ratio of the accumulated post-retirement benefit obligation of each segment to that of the plan as a whole. The accumulated value of unfunded accruals shall be allocated to segments in the same proportions as such net fair value of plan assets.

(D) Thereafter, the fair value of plan assets allocable to each segment shall be brought forward as described in paragraph (c)(6)(iii) of this subsection. The accumulated value of unfunded accruals allocated to each segment shall be brought forward in accordance with paragraph (c)(6)(v) of this subsection and the definition at 9904.419–30(a)(1).

(ii) When post-retirement benefit costs are first separately calculated for a segment, there shall be an initial allocation of the undivided values of unrecognized prior service cost, unrecognized transition obligation, and unrecognized gains and losses (including any gains or losses from curtailments, settlements, or granting termination benefits). Such values shall be allocated to the segment based on the ratio of the unfunded accumulated post-retirement benefit obligation of the segment to that of the plan as a whole. These unrecognized amounts shall be brought forward in accordance with the separately calculated post-retirement benefit cost of the segment.

(iii) After the initial allocation of the fair value of plan assets, the contractor shall maintain a record of the portion of subsequent contributions, income, benefit payments, and expenses attributable to segments and paid from the plan assets.

(A) Amounts deposited to a funding agency shall be apportioned to segments in proportion to the post-retirement benefit costs allocated to or separately calculated for the individual segments. However, if a contractor consistently follows a practice of separately calculating post-retirement benefit costs for segments, the contractor may first apportion amounts funded to segments in proportion to the post-retirement benefit cost of such segments subject to this Standard. Any portion of the amount deposited remaining after apportioning funding to segments whose costs are subject to this Standard, shall then be apportioned to other segments. No prepayment credit shall be

measured until the post-retirement benefit cost of all segments is funded.

(B) Income and expenses shall include a portion of any investment gains and losses attributable to the plan assets. Income and expenses attributable to plan assets shall be allocated to segments in the same proportion that the average value of plan assets allocated to each segment bears to the average value of total plan assets for the period for which income and expenses are being allocated.

(iv) Once the fair value of plan assets has been determined for segments in accordance with paragraphs (c)(6)(i) or (iii) of this subsection each year, the market-related value of plan assets shall be allocated to each segment in the same proportion as the fair value of plan assets.

(v) Any portion of post-retirement benefit cost of a segment for a cost accounting period that is not funded within such period shall be accounted for as an unfunded accrual and carried forward to future accounting periods. The contractor may elect to fund portions of, and thereby reduce, the accumulated value of unfunded accruals. Such funding shall not be recognized for purposes of paragraph (c)(5) of this subsection.

(vi) Amounts funded in excess of the total post-retirement benefit cost of a segment for a cost accounting period shall be accounted for as a prepayment credit and carried forward to future accounting periods. The accumulated value of prepayment credits shall be reduced for portions of the accumulated value of prepayment credits used to fund post-retirement benefit costs or to fund portions of the accumulated value of unfunded accruals.

(vii) Any benefit payments to or on behalf of a segment's plan participants which are made by the contractor from a source other than the plan assets shall be treated as funding in accordance with paragraph (c)(5) of this subsection. The accumulated value of unfunded accruals shall be reduced by any such benefit payments that exceed the assigned post-retirement benefit cost for cost accounting period.

(viii) (A) If plan participants transfer among segments or if a segment is split into two or more segments, the contractor shall transfer fair value of plan assets, accumulated value of unfunded accruals, and accumulated value of prepayment credits as follows:

(*1*) The contractor shall first allocate fair value of plan assets, accumulated value of unfunded accruals, and accumulated value of prepayment credits to the nonforfeitable post-retirement benefit obligation based on the ratio of the nonforfeitable post-retirement benefit obligation to the valuation assets. Such ratio shall not exceed one (1). Allocate any remaining fair value of plan assets, accumulated value of unfunded accruals, and accumulated value of prepayment credits to the forfeitable post-retirement benefit obligation.

(*2*) The contractor shall then transfer fair value of plan assets, accumulated value of unfunded accruals, and accumulated value of prepayment credits allocated to the nonforfeitable post-retirement benefit obligation in proportion to the nonforfeitable post-retirement benefit obligation transferred.

(*3*) Finally, the contractor shall transfer fair value of plan assets, accumulated value of unfunded accruals, and accumulated value of prepayment credits allocated to the forfeitable post-retirement benefit obligation in proportion to the forfeitable post-retirement benefit obligation transferred.

(B) In addition, a portion of each unrecognized prior service cost, unrecognized transition obligation, and unrecognized gain or loss (including any gains or losses from curtailments, settlements, or granting termination benefits) shall be transferred in proportion to the unfunded accumulated post-retirement obligation transferred. The contractor may follow a consistent practice which deems that all transfers occur at the end of the period. The undivided market-related value of plan assets shall be allocated in proportion to the fair value of plan assets of each segment after the transfer. Contractors need not transfer assets and other values if the net amount of transfers is immaterial.

(d) *Allocation of post-retirement benefit cost to cost objectives.* The allocation of post-retirement benefit cost of segments to intermediate and final cost objectives shall be made in accordance with applicable Standards.

(e) *Adjustments for curtailments, settlements, and termination benefits.*

(1) For defined-contribution plans using accrual accounting, in the event a contractor terminates a post-retirement benefit plan or curtails vesting or retirement eligibility service, then the contractor shall determine the amount of nonvested account balances subject to forfeiture. Such amount shall be determined as of the date of such plan termination or curtailment of vesting or retirement eligibility service. The amount of the credit shall be amortized and assigned over a period of ten (10) years beginning with the period in which the event occurs.

(2) For defined-benefit plans using accrual accounting:

(i) In the event a contractor curtails a post-retirement benefit plan, settles a post-retirement benefit obligation, or grants termination benefits, then the contractor shall measure the gain or loss caused by such event separately from the annual gain or loss determined for purposes of 9904.419–50(b)(2)(vii). In measuring such amount, the contractor shall apply the methods and techniques prescribed in SFAS 106. Any such gain or loss remaining after offsetting any portion of unrecognized prior service costs, prior gains and losses, or transition obligation shall be amortized and assigned over a period of ten (10) years beginning with the period in which the event occurs.

(ii) If a post-retirement benefit plan is terminated, the contracting parties may agree to establish a single plan termination amount by aggregating the net sum of any unrecognized gain or loss adjustments for curtailments, settlements, or granting of termination benefits determined in accordance with this subsection plus any remaining unrecognized net gain or loss determined in accordance with 9904.419–50(b)(2)(vii). Such plan termination amount shall be amortized and assigned over a period of ten (10) years beginning with the period in which the plan termination occurred.

(iii) If the contractor has not already allocated the fair value of plan assets and other relevant values to the segment, such an allocation shall be made in accordance with the requirements of 9904.419–50(c)(6)(i) and (ii).

(f) *Adjustments for segment closings.* If a segment is closed, the contractor shall determine a segment closing amount which represents an adjustment to previously determined post-retirement benefit costs as follows:

(1) For plans accounted for under the pay-as-you-go cost method:

(i) The contractor shall not adjust previously determined post-retirement benefit costs. Contract price or cost adjustments are not permitted.

(ii) If the segment discontinues operations, is sold, or ownership is otherwise transferred, all remaining inactive plan participants shall be transferred to the closed segment's immediate home office.

(2) For defined-contribution plans using accrual accounting, the segment closing amount shall be measured as the unrecognized portion of the plan termination or curtailment of vesting or retirement eligibility service credit determined in accordance with 9904.419–50(e)(1).

(3) For defined-benefit plans using accrual accounting:

(i) The segment closing amount shall be measured as the difference between the nonforfeitable post-retirement benefit obligation and the valuation assets.

(ii) The contractor's methods and assumptions used to determine the segment closing amount shall be consistent with those used in the measurement of post-retirement benefit costs prior to the segment closing.

(iii) If the segment discontinues operations, all remaining inactive plan participants shall be transferred to the closed segment's immediate home office, along with the accumulated post-retirement benefit obligation, fair value of plan assets and all other values attributable to such transferred inactive participants.

(iv) If the segment is sold, or ownership is otherwise transferred, and the contractor retains some or all of the accumulated post-retirement benefit obligation, the fair value of plan assets and all other values shall be split between the contractor and the buyer in accordance with 9904.419–50(c)(6)(viii) based upon the accumulated post-retirement benefit obligation retained by the contractor and the balance of the accumulated post-retirement benefit obligation which is transferred to the buyer. The accumulated post-retirement benefit obligation, fair value of plan assets and all other values retained by the contractor shall be transferred to the closed segment's immediate home office.

(v) If the segment is sold or ownership is otherwise transferred and such sale or transfer of ownership is to a successor-in-interest then:

(A) If the entire accumulated post-retirement benefit obligation, fair value of plan assets, accumulated value of unfunded accruals, and accumulated value of prepayment credits are transferred to the successor contractor, there shall be no adjustment to previously determined post-retirement benefit costs.

(B) If the contractor retains some or all of the accumulated post-retirement benefit obligation, the accumulated post-retirement benefit obligation and all other values shall be allocated between the contractor and the successor-in-interest in accordance with paragraph (f)(3)(iv) of this section. The segment closing amount shall be determined based on such retained values.

(C) The contractor's methods and assumptions are deemed to be adopted by the successor-in-interest so that the effect of the segment's transferred assets and liabilities is carried forward and recognized in the accounting for post-retirement benefit cost at the successor contractor. Any changes in methods or assumptions shall be deemed to occur immediately after such transfer.

(vi) Once determined, any adjustment credit shall be first used to reduce the accumulated value of unfunded accruals. After the accumulated value of unfunded accruals has been reduced, any remaining adjustment amount shall be accounted for as a prepayment credit. Any adjustment charge shall be accounted for as an unfunded accrual to the extent that funds are not added to the fair value of assets.

(4) The Government's share of the segment closing amount (charge or credit) shall be the product of the total segment closing amount determined in accordance with paragraphs (f)(2) or (3) of this subsection and a fraction. The numerator of such fraction shall be the sum of the post-retirement benefit plan costs allocated to all contracts and subcontracts (including Foreign Military Sales) subject to this Standard during a period of years representative of the Government's participation in the post-retirement benefit plan costs on an accrual basis. The denominator of such fraction shall be the total post-retirement benefit plan costs assigned to cost accounting periods during the same period. The contracting parties shall recognize the Government's share of the segment closing amount that is applicable to the segment's contracts that are subject to this Standard by adjusting contract prices, target costs or cost ceilings, or, by any other suitable technique acceptable to the cognizant Federal agency official.

(5) For purposes of this subsection and paragraph (e) of this section, if the date of the event is not readily determinable, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date.

**9904.419–60 Illustrations.**

These illustrations presume that the contractor's post-retirement benefit plan, cost methods, and actuarial assumptions meet the requirements of this Standard except as noted in the particular illustration.

(a) *Recognition of post-retirement benefit costs.*

(1) The written terms of Contractor A's defined-contribution post-retirement plan require that the contractor make contributions of a specified percentage of each employee's base salary to individual accounts held by an organization that satisfies the 9904.419–30(b)(2) definition of a funding agency. Upon retirement each employee's accumulated account balance is annuitized and used to pay a portion of the annual premium on the retiree's ''Medigap'' health insurance policy purchased from an non-captive insurance carrier. Pursuant to 9904.419–40(a)(1)(iv), the contractor determines the cost of its defined-contribution plan for each cost accounting period as the sum of the required net contributions deposited into the individual participants' accounts held by the funding agency.

(2) Contractor B sponsors a defined-benefit retiree health plan which historically has been amended every three (3) years to increase the amounts of the annual deductible and copayment. This post-retirement benefit plan meets the criteria for accrual accounting set forth in 9904.419–40(a)(1). Pursuant to 9904.419–40(a)(1)(v), the contractor must actuarially determine the cost of its post-retirement benefit plan for the current period based upon the deductible and copayment amounts specified in the current written plan document. Pursuant to 9904.419–50(b)(2)(ii), the actuarial gain attributable to any future amendment increasing the deductible and copayment can not be recognized until such amendment is adopted.

(3) Contractor C has historically paid a percentage of the health insurance premiums for its retirees. Each year the contractor has renewed its intent to continue this program for the upcoming year in a letter to its retirees. Although active employees are occasionally informally told of this program, especially as they prepare to retire, the program is not mentioned in the employee handbook nor any other employee communication. However, the letter was not sent to all plan participants, did not include a notice of the right to legally enforce payment of the benefit, and did not provide an irrevocable right to the benefit once participants had attained eligibility. In accordance with 9904.419–40(a)(2), the cost of this post-retirement health plan must be accounted for using the pay-as-you-go cost method because the criteria set forth at 9904.419–40(a)(1)(i) and (ii) were not met.

(4) Contractor D sponsors a retiree life insurance program that provides a death benefit equal to 35% of an employee's final earnings, subject to a minimum death benefit of $10,000. This defined-benefit post-retirement plan meets the criteria set forth in 9904.419–40(a)(1). The contractor pays an annual premium to an non-captive insurer to provide a $10,000 participating life insurance

policy for all employees at retirement. Pursuant to 9904.416–50(a)(1)(i) of Cost Accounting Standard 9904.416, the contractor's established practice is to adjust the annual insurance premium for any refunds, dividends, additional assessments, or other credits or charges, in the cost accounting period in which such credit or charge is received or receivable. The cost for the projected benefit that exceeds $10,000 must be accounted for as a defined-benefit plan using accrual accounting in accordance with 9904.419–40(b)(2)(iii). Pursuant to 9904.419–40(b)(2), the cost for a cost accounting period is the premium paid to provide the basic $10,000 death benefit, adjusted in accordance to 9904.416–50(a)(1)(i), plus the annual amount determined in accordance with the accrual accounting provisions of this Standard relating to defined-benefit post-retirement benefit plans. If the insurance had been obtained from a captive insurer as defined by 9904.419–30(a)(3), the entire cost of the plan would have been subject to this Standard in accordance with 9904.419–40(b)(2)(ii).

(5) Contractor E sponsors two post-retirement benefit plans which each have a separate plan document. One plan provides retiree health benefits for all employees of the contractor. The other plan provides retiree dental and vision benefits for the same employees. Neither plan meets the criteria specified at 9904.419–40(a)(1) and therefore, are required to be accounted for using the pay-as-you-go method in accordance with 9904.419–50(a)(2). Pursuant to 9904.419–50(a)(1)(i), the contractor may elect to determine the cost of the two plans on an aggregate basis.

(6) Contractor F sponsors two defined-benefit post-retirement plans which each have a separate plan document. One plan provides health benefits to all retired salaried employees. The other plan provides the same health benefits to all retired bargaining unit employees. Because both plans satisfy the criteria of 9904.419–50(a)(1), both are required to use accrual accounting. Pursuant to 9904.419–50(a)(1)(ii), the contractor may elect to determine the cost of the two plans on an aggregate basis.

(7) Contractor G sponsors a single post-retirement benefit plan that provides health benefits and life insurance benefits. The contractor has retained the right to terminate the health benefits for all but those employees who are retired or have attained eligibility for benefits. The contractor pays level annual premiums to an non-captive insurance carrier designed to provide paid-up participating life insurance contracts by the time an employee reaches retirement and the employees have an irrevocable right to the current value of the insurance contracts. The contractor's established practice is to adjust the annual participating insurance premium by the amount of estimated refunds and dividends in accordance with 9904.416–50(a)(1)(vi) of Cost Accounting Standard 9904.416, and therefore such adjusted level annual premiums satisfy the requirements of 9904.419–40(b)(2)(i). Because the plan satisfies the criteria set forth at 9904.419–40(a)(1), the contractor must account for the cost of the benefits not provided through insurance contracts using accrual accounting as required by 9904.419–50(b)(2)(iii). Alternatively, 9904.419–40(a)(2) permits the contractor to separately identify and account for the cost of the life insurance benefit as if it were a separate post-retirement benefit plan.

(8) Contractor H has a single defined-benefit post-retirement plan. The plan provides one set of benefits to retirees and employees who were eligible to retire on or before December 31, 1995 (the ''protected group''). Under the terms of the post-retirement benefit plan, the contractor has no right to reduce these benefits. Employees eligible for retirement on or after January 1, 1996 are provided a less generous set of benefits and the contractor retains the right to terminate the plan or reduce benefits even after eligibility is attained. Because the plan does not fully satisfy the criteria set forth at 9904.419–40(a)(1), the pay-as-you-go method must be used to account for the cost of the plan. Pursuant to 9904.419–50(a)(3), the contractor may identify the benefits provided to the two groups as being provided by separate post-retirement benefit plans. In that case, because the costs for the ''protected group'' plan meet the requirements of 9904.419–40(a)(1), the ''protected group'' plan must be actuarially determined and accounted for using accrual accounting. In accordance with 9904.419–40(a)(2), the contractor must account for the benefits of the plan for the post-1995 retirees using the pay-as-you-go cost method because that separately identified plan fails the criteria of 9904.419–40(a)(1).

(9) Contractor I sponsors a post-retirement benefit plan that provides a life insurance benefit of two-times final salary for all employees. The program also provides that the contractor will deposit 1% of each employee's pay into individual accounts held by a funding agency. At retirement, the accumulated value of the individual account is used to purchase a paid-up life insurance policy. If the funds in the individual account is insufficient to purchase the full life insurance benefit, the contractor pays the additional cost directly from general corporate resources. This program has features of both a defined-benefit and a defined-contribution post-retirement plan. Since the substance of the plan is to provide a defined-benefit life insurance of two-times final salary, then pursuant to 9904.419–50(a)(4), the annual cost must be determined in accordance with the provisions of this Standard relating to defined-benefit post-retirement plans.

(b) *Measurement and assignment of post-retirement benefit cost.*

(1) Contractor J uses the pay-as-you-go cost method to determine the cost of its retiree life insurance program. During the current period, the contractor paid $200,000 in death benefits directly to the named beneficiaries of deceased plan participants which is the pay-as-you-go cost for current benefits in accordance with 9904.419–40(b)(3)(i). On the first day of the current period, the contractor also paid $180,000 in premiums to purchase paid-up insurance policies from an non-captive insurer for certain employees as they retired during the current year. The prevailing rate determined by the Secretary of the Treasury pursuant to Public Law 92–41, 85 Stat. 97 for the current period is 7.25%. Pursuant to 9904.419–40(b)(2)(iv) and 9904.419–40(b)(3)(ii) and 9904.419–50(b)(1), the contractor determines the current period cost of the paid-up insurance policies as $18,719, which is the annual amount required to amortize the $180,000 in fifteen (15) equal annual payments at 7.25%. The contractor determines the total cost for the current period as $218,719 ($200,000 + $18,719).

(2) Contractor K sponsors a defined-contribution post-retirement plan which satisfies the criteria set forth at 9904.419–40(a)(1). The plan is funded through a dedicated trust that qualifies as a funding agency. The plan document provides that each year the contractor will credit to the individual accounts of the plan participants an amount equal to 5% of each employee's base salary less that employee's share of any nonvested account balances forfeited by terminating employees. The annual contribution amount so determined constitutes the post-retirement benefit cost in accordance with 9904.419–40(b)(4). Any amount not funded by a deposit to the funding agency must be identified as an unfunded accrual in accordance with 9904.419–50(c)(6)(v).

(3) Conversely, assume that the plan sponsored by Contractor K in illustration 9904.419–60(b)(2) fails the

criteria set-forth at 9904.419–40(a)(1). Also assume that the contractor maintains memorandum records of the participants' account balances, rather than fund this defined-contribution plan. At retirement the contractor pays the employees the value of account balances recorded in these memorandum records as a lump sum settlement of the account balance. In this case the contractor shall use the pay-as-you-go cost method in accordance with 9904.419–40(a)(2). In accordance with 9904.419–40(b)(3), the cost shall be based upon the lump sum settlements paid to the plan participants and amortized in accordance with 9904.419–40(b)(3)(ii). If prior to becoming subject to this Standard, the contractor had accounted for the costs of its post-retirement benefit plan using terminal funding, the contractor could continue to use terminal funding as its cost accounting practice as permitted by 9904.419–64(d). In that case, no amortization would be required.

(4) Contractor L sponsors a post-retirement benefit plan for its collective bargaining employees which satisfy the requirements of 9904.419–40(a)(1). The contractor uses the projected unit credit actuarial cost method and a discount rate of 7.5% to determine the net periodic post-retirement benefit cost for SFAS 106 purposes, and therefore, 9904.419–50(a)(1)(i) requires that the contractor use the projected unit credit actuarial cost method and 7.5% discount rate assumption for contract cost accounting purposes. The contractor funds the plan through a combination of an Internal Revenue Code (IRC) section 401(h) account, whose assets are separately accounted for within a qualified defined-benefit pension trust, plus an IRC section 501(c)(9) voluntary employee benefit trust, otherwise known as a VEBA. The contractor determines the annual deposit for the IRC 401(h) account using the aggregate actuarial cost method, and for the VEBA using the projected unit credit actuarial cost method. Both of these deposit determinations are based on an assumption of 7% for the discount rate. The deposits to the IRC 401(h) account and the VEBA are used to determine the funded portion of the post-retirement benefit cost for purposes of 9904.419-50(c)(5), but not the contract cost. To the extent that the deposits in any cost accounting period differ from the post-retirement benefit cost determined pursuant to this Standard, the shortfall or excess shall be identified as either an unfunded accrual or a prepayment credit in accordance with 9904.419–50(c)(6)(v) and (vi), respectively.

(5)(i) The actuarial valuation report prepared for SFAS 106 purposes gives the following information reconciling the funded status of the defined-benefit post-retirement plan sponsored by Contractor M:

| | Value as of 12/31 |
|---|---|
| Accumulated post-retirement benefit obligation | ($257,000) |
| Fair value of plan assets | 69,000 |
| Funded status | (188,000) |
| Unrecognized net gain | (44,000) |
| Unrecognized prior service cost | 33,000 |
| Unrecognized transition obligation | 195,000 |
| Net pre-paid (accrued) post-retirement benefit cost | (4,000) |

(ii) The terms of the plans satisfy the requirements of 9904.419–40(a)(1). Three years ago the contractor did not fund all of its assigned post-retirement benefit cost for the period and has separately identified and maintained an accumulated value of unfunded accruals which is currently valued at $6,000 in accordance with definition 9904.419–30(a)(1) and 9904.419–50(c)(6)(v). Two years ago, the contractor funded an amount greater than its assigned post-retirement benefit cost for the period and has separately identified and accounted for the excess as the accumulated value of prepayment credits which is currently valued at $2,000 in accordance with definition 9904.419–30(b)(5) and 9904.419–50(c)(6)(vi). During all other years the contractor exactly funded its post-retirement benefit cost. In accordance with the definition at 9904.419–30(a)(15), the contractor determines the unfunded accumulated post-retirement benefit obligation for contract cost accounting purposes as $184,000, which is the $257,000 accumulated post-retirement benefit obligation less the sum of $69,000 of fair value of plan assets and $6,000 of accumulated unfunded accruals plus the $2,000 accumulated value of prepayment credits. The contractor determines that the sum of the unrecognized net gain, unrecognized prior service cost and unrecognized transition obligation is $184,000 ($(44,000) + $33,000 + $195,000). Pursuant to 9904.419–40(b)(5)(iv), the cost determined for the current period is assignable to the period because the unfunded accumulated post-retirement benefit obligation equals the sum of the unrecognized amounts as shown below:

| | Value as of 12/31 |
|---|---|
| Accumulated post-retirement benefit obligation: | |
| Retirees receiving benefits | $82,000 |
| Actives—Currently eligible for benefits | 19,000 |
| Nonforfeitable post-retirement benefit obligation | 101,000 |
| Actives—Not yet eligible for benefits | 156,000 |
| Total | 257,000 |
| Valuation Assets: | |
| Fair value of plan assets | (69,000) |

| | Value as of 12/31 |
|---|---|
| Accumulated value of unfunded accruals | (6,000) |
| Accumulated value of prepayment credits | 2,000 |
| Total | (73,000) |
| Unfunded accumulated post-retirement benefit obligation | 184,000 |
| Unrecognized net gain | (44,000) |
| Unrecognized prior service cost | 33,000 |
| Unrecognized transition obligation | 195,000 |
| Sum of unrecognized amounts | 184,000 |
| Result of 9904.419–40(b)(5)(iv) balance test | Passes |

(6) Contractor M in illustration 9904.419–60(b)(5) determines that during the following year the actual return on the fair value of plan assets of $69,000 is $7,200 for SFAS 106 purposes. The current interest rate determined by the Secretary of the Treasury pursuant to Public Law 92–41, 85 Stat. 97 is 9.5%. Pursuant to 9904.419–50(b)(2)(iv), the contractor increases the $7,200 actual return on the fair value of plan assets by the interest imputed on the accumulated value of unfunded accruals which is 9.5% of $6,000 or $570. Pursuant to 9904.419–50(b)(2)(v), the contractor reduces the actual return on the fair value of plan assets by the interest imputed on the accumulated value of prepayment credits which is 9.5% of $2,000 or $190. For contract cost purposes, the contractor determines the actual return on the fair value of plan assets as $7,580 ($7,200 + $570–$190).

(7) Assume that Contractor M in Illustration 9904.419–60(b)(5) determines that the sum of the components of post-retirement benefit cost, as described in 9904.419–40(b)(5), is $55,000. The contractor also pays $15,000 for benefits incurred by current retirees during the period which can be considered funding in accordance with 9904.419–50(c)(6)(vii). Furthermore, as shown in Illustration 9904.419–60(b)(5), the nonforfeitable post-retirement benefit obligation, as defined at 9904.419–30(a)(7), is $101,000. Therefore, the unfunded nonforfeitable post-retirement benefit obligation is $28,000 (nonforfeitable post-retirement benefit obligation of $101,000 minus valuation assets of $73,000.) In accordance with 9904.419–40(b)(5)(iii) the amount of post-retirement benefit cost assignable to the current period is limited to $43,000 ($15,000 benefit payments plus $28,000 unfunded post-retirement benefit obligation.) Furthermore, the $12,000 of post-retirement benefit cost that is not assignable to the current period ($55,000–43,000) shall be recognized in future periods as an experience loss.

(8) Assume that Contractor M in illustration 9904.419–60(b)(7) makes a deposit of $26,000 into a dedicated trust fund that satisfies the definition of a funding agency found at 9904.419–30(b)(2). Section 9904.419–50(c)(6)(vi) permits the $2,000 accumulated value of prepayment credits to be applied toward the $43,000 cost so that the full current period cost is funded for purposes of 9904.419–0(c)(6)(v). Therefore, the total amount available towards funding the cost assigned to the current period is $43,000 ($26,000 deposit + $15,000 benefit payments + $2,000 prepayment credit). The accumulated value of prepayment credits must be reduced by the amount applied towards the current year's cost in accordance with 9904.419–50(c)(6)(v) and definition 9904.419–30(b)(3).

(9) If in illustration 9904.419–60(b)(7), Contractor M had only deposited $23,000 into the dedicated trust fund, the total amount available towards funding the cost assigned to the current period would be $40,000 ($23,000 + $15,000 + $2,000). The accumulated value of unfunded accruals would increase by $3,000 to $9,000 in accordance with 9904.419–50(c)(6)(v) and definition 9904.419–30(a)(1).

(10) If in illustration 9904.419–60(b)(7), Contractor M had deposited $28,750 into the dedicated trust fund, the total amount available towards funding the cost assigned to the current period would be $45,750 ($28,750 + $15,000 + $2,000). The accumulated value of prepayment credits would increase by a net of $750 ($2,750 excess funding less $2,000 prepayment used) to $2,750 in accordance with 9904.419–50(c)(6)(vi)and definition 9904.419–30(b)(5).

(c) *Post-retirement benefit cost of segments.*

(1) Contractor N sponsors a retiree medical plan that covers employees who retired before January 1, 1997. All active employees and subsequent retirees are covered in a separate post-retirement benefit plan. The contractor determines the costs of the pre-1997 plan using the pay-as-you-go cost method. The plan covers retired participants from 12 segments. The contractor maintains a record of how many years each retiree worked in each segment which is used to allocate the total cost to segments. This method is acceptable under 9904.419–50(c)(1)(i).

(2) Contractor N in illustration 9904.419–60(c)(1) maintains a record of the segment where each retiree was last employed and, in accordance with 9904.419–50(c)(1)(i), uses these records to allocate the total post-retirement benefit cost to segments. Assume that two of the twelve segments associated with current retirees ceased to exist because the segments either discontinued operations or were abandoned. Pursuant to 9904.419–50(f)(1)(ii), the inactive participants of the two defunct segments have been moved to their immediate home office to which the segment had reported. The cost associated with these inactive participants must be allocated to the immediate home office for those segments and then allocated as a residual cost of that home office following the methodology of Cost Accounting Standard 9904.403.

(3) Assume Contractor N's in illustration 9904.419–60(c)(2) merges together two of the 12 segments. After the merger, the contractor uses the combined records of the two segments and treats the retirees as if they were last employed in the newly merged segment. And, in accordance with 9904.419–50(c)(1)(i), uses these records to allocate the total post-retirement benefit cost to segments. This method is acceptable under 9904.419–50(c)(1)(i).

(4) Contractor O sponsors a post-retirement benefit plan providing medical and life insurance benefits for its active employees. The accrual accounting cost of the medical benefit is actuarially determined by each participant's age and gender. The actuarially determined cost of the life insurance benefit is based upon the employee's expected final salary and age group. As permitted by 9904.419–50(a)(2), the contractor determines the costs of the medical and life benefits as if they were provided through two separate plans. Pursuant to 9904.419–40(c)(1), each home office that has plan participants is treated as a segment. None of the conditions set forth in 9904.419–50(c)(2) exists so the contractor calculates a composite post-retirement benefit cost for each benefit. In accordance with 9904.419–40(c)(2), the contractor indirectly allocates the costs of each benefit to segments. In accordance with 9904.419–50(c)(1)(ii), the cost of the medical benefit is allocated using the number of active plan participants in each segment, including home offices. The cost of the life insurance benefit, which is dependent upon each participant's final salary, is allocated to each segment, including home offices, using the salaries of active plan participants.

(5) Contractor P uses the pay-as-you-go cost method for its post-retirement medical program for employees of several segments each of which is in a different state. While the benefits are similar, the payments vary significantly by type of contract and geographical region. Pursuant to 9904.419–50(c)(1)(i) the contractor must allocate the post-retirement benefit cost for each segment based upon the benefit payments that are identifiable with each of the segments. Furthermore, any material gain or loss attributable to the plan participants of a particular segment, must also be directly allocated to that segment only in accordance with 9904.419–50(c)(1)(i).

(6) Contractor Q uses accrual accounting to calculate the composite costs for each of two different defined-benefit plans. Only one of the two plans covers the employees of any one segment. Pursuant to 9904.419–40(c)(1), the composite cost of each distinct plan is allocated only to those segments having participants in that plan. In the past Plan I has covered the employees of Segment G. As part of an internal reorganization, the post-retirement benefit plans were amended so that benefits for employees of Segment G will now be provided through Plan II. For government contract cost accounting purposes, the assets that move with Segment G from Plan I to Plan II are the assets initially allocated to Segment G in accordance with 9904.419–50(c)(6)(i). The ratio of accumulated post-retirement benefit obligation to the valuation assets, as defined at 9904.419–30(a)(16), for segment G is X%, which materially differs from such ratio for the other segments covered by Plan II. In accordance with 9904.419–50(c)(2)(v), the contractor will have to begin separately calculating post-retirement benefit costs for Segment G. The contractor may continue to determine post-retirement benefit costs for the original Plan II segments in the aggregate as long as none of the conditions of 9904.419–50(c)(2) exists for any of these segments.

(7) Assume Contractor R has five segments directed by one home office. One segment, Segment A, does a majority (85%) of its work under Government contracts. Segment B provides support services to the other four segments. The other three segments, Segments C, D, and E perform only commercial-type work. The post-retirement benefit plans meets the criteria set forth at 9904.419–40(a)(1) and the contractor uses accrual accounting to separately calculate post-retirement benefit costs for the home office and each of the five segments in accordance with 9904.419–40(c)(1) and 9904.419–50(c)(1)(ii). Pursuant to 9904.419–50(c)(6)(iii)(A), the contractor may ascribe funding to the costs allocated to the home office, Segment A, and Segment B before ascribing any funding to the three commercial segments. The separate accounting records of each segment which are maintained in accordance with 9904.419–50(c)(6)(iii) must reflect that the funding was first apportioned to the home office, Segment A and Segment B which allocate post-retirement benefit costs to contracts subject to this Standard.

(8)(i) Contractor R in Illustration 9904.419–60(c)(7) transfers 50 active plan participants in its defined-benefit plan from Segment A to Segment D as part of adjusting its staffing to match its workload. The accumulated post-retirement benefit obligation for these 50 participants is $250,000 of which $50,000 is attributable to active participants who are fully eligible for benefits and $200,000 is attributable to active participants who are not currently eligible for benefits. The segment accounting for Segments A and D immediately before the transfer is:

| | Segment A | Segment D |
|---|---|---|
| Accumulated post-retirement benefit obligation: | | |
| Retirees receiving benefits | $750,000 | 225,000 |
| Actives—Currently eligible | 250,000 | 175,000 |
| Nonforfeitable post-retirement benefit obligation | 1,000,000 | 400,000 |
| Actives—Not yet eligible | 2,000,000 | 1,600,000 |
| Total | 3,000,000 | 2,000,000 |
| Valuation Assets: | | |
| Fair value of plan assets [1] | (1,000,000) | |
| Accumulated value of unfunded accruals | (200,000) | (750,000) |
| Accumulated value of prepayment credits [2] | | |
| Total | (1,200,000) | (750,000) |
| Unfunded accumulated post-retirement benefit obligation | 1,800,000 | 1,250,000 |
| Unrecognized transition obligation | 2,000,000 | 1,400,000 |
| Unrecognized prior service cost | 100,000 | 50,000 |
| Unrecognized (gain) or loss | (300,000) | (200,000) |
| Sum of unrecognized amounts | 1,800,000 | 1,250,000 |

| | Segment A | Segment D |
|---|---|---|
| Results of 9904.419–40(b)(5)(iv) balance test | Passes | Passes |

[1] In accordance with 9904.419–50(c)(6)(i), the fair value of plan assets allocated to segments excludes the accumulated value of prepayment credits.

[2] In accordance with 9904.419–50(c)(6)(i), the accumulated value of prepayment credits were separately identified and were not allocated to segments.

(ii) The contractor must first allocate fair value of plan assets, accumulated value of unfunded accruals, and accumulated value of prepayment credits to the nonforfeitable post-retirement benefit obligation in accordance with 9904.419–50(c)(6)(viii)(A). The ratio of the nonforfeitable post-retirement benefit obligation to the sum of the fair value of plan assets, accumulated value of unfunded accruals, and accumulated value of prepayment credits is 0.833333 ($1,000,000 divided by $1,200,000). Therefore the contractor allocates $833,333 (83.3333% of $1,000,000) of the fair value of plan assets, $166,667 (83.3333% of $200,000) of accumulated value of unfunded accruals. (In accordance 9904.419–50(c)(6)(i), the accumulated value of prepayment credits were separately identified and were not allocated to segments.) The balance of the fair value of plan assets ($166,667) and accumulated value of unfunded accruals ($33,333) are allocated to the forfeitable post-retirement benefit obligation.

(iii) Then, because 5% ($50,000 of $1,000,000) of the nonforfeitable post-retirement benefit obligation was transferred to Segment D, the contractor transfers $41,667 (5% of $833,333) of the fair value of plan assets and $8,333 (5% of $166,667) of accumulated value of unfunded accruals allocated to the nonforfeitable post-retirement benefit obligation to Segment D in accordance with 9904.419–50(c)(6)(viii)(B).

(iv) Finally, because 10% ($200,000 of $2,000,000) of the forfeitable post-retirement benefit obligation was transferred to Segment D, $16,667 (10% of $166,667) of the fair value of plan assets and $3,333 (10% of $33,333) of accumulated value of unfunded accruals allocated to the forfeitable post-retirement benefit obligation is transferred to segment D in accordance with 9904.419–50(c)(6)(viii)(C).

(v) The unfunded nonforfeitable post-retirement benefit obligation transferred to Segment D is $180,000, which is 10% of the original unfunded accumulated post-retirement benefit obligation for Segment A. The contractor transfers 10% of the unrecognized transition obligation, unrecognized prior service cost, and unrecognized gains and losses from Segment A to Segment D in accordance with 9904.419–50(c)(6)(viii).

(vi) The segment accounting for Segment A for the transfer is shown below:

| | Segment A | | |
|---|---|---|---|
| | Before transfer | Transfer to segment D | After transfer |
| Accumulated post-retirement benefit obligation: | | | |
| Retirees receiving benefits | $750,000 | ..... | $750,000 |
| Actives—Currently eligible | 250,000 | $(50,000) | 200,000 |
| Nonforfeitable post-retirement benefit obligation | 1,000,000 | (50,000) | 950,000 |
| Actives—Not yet eligible | 2,000,000 | (200,000) | 1,800,000 |
| Total | 3,000,000 | (250,000) | 2,750,000 |
| Valuation Assets: | | | |
| Fair value of plan assets | (1,000,000) | 58,334 | (941,666) |
| Accumulated value of unfunded accruals | (200,000) | 11,666 | (188,334) |
| Accumulated value prepayment credits | ..... | ..... | ..... |
| Total | (1,200,000) | 70,000 | (1,130,000) |
| Unfunded accumulated post-retirement benefit obligation | 1,800,000 | (180,000) | 1,620,000 |
| Unrecognized transition obligation | 2,000,000 | (200,000) | 1,800,000 |
| Unrecognized prior service cost | 100,000 | (10,000) | 90,000 |
| Unrecognized (gain) or loss | (300,000) | 30,000 | (270,000) |
| Sum of unrecognized amounts | 1,800,000 | (180,000) | 1,620,000 |
| Results of 9904.419–40(b)(5)(iv) balance test | Passes | Passes | Passes |

(vii) And the segment accounting for Segment D for the transfer is:

| | Segment D | | |
|---|---|---|---|
| | Before transfer | Transfer from segment A | After transfer |
| Accumulated post-retirement benefit obligation: | | | |
| Retirees receiving benefits | $225,000 | ..... | $225,000 |

| | Segment D | | |
|---|---|---|---|
| | Before transfer | Transfer from segment A | After transfer |
| Actives—Currently eligible | 175,000 | $50,000 | 225,000 |
| Nonforfeitable post-retirement benefit obligation | 400,000 | 50,000 | 450,000 |
| Actives—Not yet eligible | 1,600,000 | 200,000 | 1,800,000 |
| Total | 2,000,000 | 250,000 | 2,250,000 |
| Valuation Assets: | | | |
| Fair value of plan assets | ..... | (58,334) | (58,334) |
| Accumulated value of unfunded accruals | (750,000) | (11,666) | (761,666) |
| Accumulated value prepayment credits | ..... | ..... | ..... |
| Total | (750,000) | (70,000) | (820,000) |
| Unfunded accumulated post-retirement benefit obligation | 1,250,000 | 180,000 | 1,430,000 |
| Unrecognized transition obligation | 1,400,000 | 200,000 | 1,600,000 |
| Unrecognized prior service cost | 50,000 | 10,000 | 60,000 |
| Unrecognized (gain) or loss | (200,000) | (30,000) | (230,000) |
| Sum of unrecognized amounts | 1,250,000 | 180,000 | 1,430,000 |
| Results of 9904.419–40(b)(5)(iv) balance test | Passes | Passes | Passes |

(viii) The $180,000 increase in the unfunded accumulated post-retirement benefit obligation for Segment D will be reflected in future post-retirement benefits costs of Segment D through the increases in the unrecognized portions of transition obligation, prior to service costs, and gains and losses.

(9) Assume that the post-retirement benefit plan of Contractor R in illustration 9904.419–60(c)(8) that covers employees of Segment A and D provides more generous benefits to employees of Segment D. Accordingly, the contractor separately calculates post-retirement benefit costs for each segment pursuant to 9904.419–50(c)(2)(i) and 9904.419–40(c)(3)(ii). After the 50 plan participants are transferred from Segment A to Segment D, these employees are then eligible for the more generous benefits afforded to employees of Segment D. Based on the benefits of Segment A, the accumulated post-retirement benefit obligation for the 50 participants was $250,000. The accumulated post-retirement benefit obligation for these employees will be $283,000 based on the benefits for Segment D. After completing the transfer of accumulated post-retirement benefit obligation, fair value of plan assets and other values as shown in illustration 9904.419–60(c)(8) in accordance with 9904.419–50(c)(6)(viii), the contractor shall recognize the $33,000 increase in the accumulated post-retirement benefit obligation as an experience loss for Segment D. This experience loss shall be assigned to cost accounting periods in accordance with 9904.419–50(b)(2)(vii).

(10) Contractor S calculates a composite post-retirement benefit cost of $200,000 for its defined-benefit plan for the current cost accounting period, which the contractor then allocates to segments. The plan's benefit is not related to salary and the actuarial valuation of the post-retirement benefit liability is performed on a per-capita basis. Segment A contains 30% of all the active and inactive plan participants of the post-retirement benefit plan, and therefore Segment A is allocated $60,000 of the cost pursuant to 9904.419–50(c)(1)(ii). The $60,000 of post-retirement benefit cost allocated to Segment A is allocable to the intermediate and final cost objectives of Segment A pursuant to 9904.419–40(d). The allocation to segments is summarized as follows:

| | Allocation of composite cost | | | | |
|---|---|---|---|---|---|
| | Composite cost | Home office | Segment A | Segment B [1] | Commercial segments [2] |
| *Plan Participants:* | | | | | |
| Actives | 1,794 | 90 | 535 | 181 | 988 |
| | 206 | 10 | 65 | 19 | 112 |
| Inactives | 2,000 | 100 | 600 | 200 | 1,100 |
| Total. | | | | | |
| *Allocation to Segments:* | | | | | |
| Assigned post-retirement benefit cost | $200,000 | $10,000 | $60,000 | $20,000 | $110,000 |
| Contribution | 200,000 | 10,000 | 60,000 | 20,000 | 110,000 |
| Unfunded Accrual | ..... | ..... | ..... | ..... | ..... |

(11) Assume that Contractor S in illustration 9904.419–60(c)(10) separately calculates post-retirement benefit costs for each segment which total $200,000 for plan as a whole for the current period. The separately calculated cost is $10,000 for the Home Office, $60,000 for Segment A, and $20,000 for Segment B. Pursuant to 9904.419–50(c)(6)(iii)(A), the contractor follows its established practice and funds $90,000 which is the total cost for

the home office and two segments that allocate costs to contracts subject to this Standard. The contractor funds none of the assigned post-retirement benefit cost separately computed for the commercial segments. In this case, the $90,000 of funded post-retirement benefit cost is allocated to the Home Office, Segment A, and Segment B. Because no funding was allocated to the commercial segments, an unfunded accrual of $110,000 shall be identified as the unfunded portion of post-retirement benefit costs allocated to the commercial segments in accordance with 9904.419–50(c)(6)(v). The allocation to segments is summarized as follows:

| | Allocation separately calculated costs | | | | |
|---|---|---|---|---|---|
| | Totals | Home office | Segment A | Segment B | Commercial segments |
| *Allocation to Segments:* | | | | | |
| Separately calculated post-retirement benefit cost | $200,000 | $10,000 | $60,000 | $20,000 | $110,000 |
| less: Contribution | 90,000 | 10,000 | 60,000 | 20,000 | ..... |
| | $110,000 | ..... | ..... | ..... | 110,000 |
| Unfunded accrual | ..... | ..... | ..... | ..... | ..... |

(12) Assume that Contractor S in illustration 9904.419–60(c)(11) funds only $81,000 which is less than the separately calculated post-retirement benefit costs for the Home Office, Segment A, and Segment B. Pursuant to 9904.419–50(c)(6)(iii)(A), the contractor follows its established practice and proportionately allocates the $81,000 to only these three segments that allocate costs to contracts subject to this Standard. No funding is allocated to the commercial segments. The $81,000 is identified as the funded portion of post-retirement benefit cost for the Home Office, Segment A, and Segment B. An unfunded accrual of $9,000 is established in accordance with 9904.419–50(c)(6)(v) and allocated to these three segments. The allocation to segments is summarized as follows:

| | Allocation of separately calculated costs | | | | |
|---|---|---|---|---|---|
| | Composite cost | Home office | Segment A | Segment B | Commercial segments |
| *Allocation to Segments:* | | | | | |
| Separately calculated post-retirement benefit cost | $200,000 | 10,000 | 60,000 | 20,000 | 110,000 |
| | 81,000 | 9,000 | 54,000 | 18,000 | |
| less: Contribution | 119,000 | 1,000 | 6,000 | 2,000 | 110,000 |
| Unfunded accrual | | | | | |

(13) Assume that Contractor S in illustration 9904.419–60(c)(11) funds $108,000, which is more than the separately calculated post-retirement benefit costs for the Home Office, Segment A, and Segment B. Pursuant to 9904.419–50(c)(6)(iii)(A), the contractor follows its established practice and first allocates $90,000 of the funding to the three segments that allocate costs to contracts subject to this Standard. The contractor then allocates the remaining $18,000 of funding to the commercial segments. The $92,000 unfunded portion of post-retirement benefit cost separately calculated for the commercial segments shall be identified as an unfunded accrual of $92,000 must be established in accordance with 9904.419–50(c)(6)(v). The allocation to segments is summarized as follows:

| | Allocation of separately calculated costs | | | | |
|---|---|---|---|---|---|
| | Composite cost | Home office | Segment A | Segment B | Commercial segments |
| *Allocation to Segments:* | | | | | |
| Net post-retirement benefit cost | $200,000 | $10,000 | $60,000 | $20,000 | $110,000 |
| | 108,000 | 10,000 | 60,000 | 20,000 | 18,000 |
| less: Contribution | 92,000 | 0 | 0 | 0 | 92,000 |
| Unfunded accrual | | | | | |

(d) *Allocation of post-retirement benefit cost to cost objectives.* [Reserved]

(e) *Adjustments for curtailments, settlements, and termination benefits.*

(1)(i) Assume that Contractor M in illustration 9904.419–60(b)(5) announces that it will reduce its

operations by terminating a significant number of employees at the end of the current period. Pursuant to SFAS 106, the contractor recognizes that a curtailment of benefits has occurred because the termination of the employees causes a reduction in the remaining years of expected service associated with those terminating employees. The termination of employees also causes a reduction in the accumulated post-retirement benefit obligation because some of the terminated plan participants will not accrue the future service necessary for benefits eligibility. Also assume that because of the work-force reduction, a certain class of the terminated employees becomes eligible for special termination benefits which increase the accumulated post-retirement benefit obligation by $14,000. For SFAS 106 purposes the contractor determines the special termination benefit loss and the curtailment gain as follows:

| | SFAS 106 accounting as of December 31 | | | |
|---|---|---|---|---|
| | Before curtailment | Special termination benefits | Curtailment gain | After curtailment |
| Accumulated post-retirement benefit obligation | $(257,000) | [1]$(14,000) | [2] $68,000 | $(203,000) |
| Fair value of plan assets | 69,000 | | | 69,000 |
| Funded status | (188,000) | (14,000) | 68,000 | (134,000) |
| Unrecognized net gain | (44,000) | | | (44,000) |
| Unrecognized prior service cost | 33,000 | | [3] (5,940) | 27,060 |
| Unrecognized transition obligation | 195,000 | | [4] (42,900) | 152,100 |
| Pre-paid (accrued) post-retirement benefit cost | [5] (4,000) | (14,000) | 19,160 | 1,160 |

[1] Increase in accumulated post-retirement benefit obligation attributable to the additional benefits granted under special termination provisions of the post-retirement benefit plan.
[2] Gain due to decrease in accumulated post-retirement benefit obligation because terminated participants will not become eligible for full benefits.
[3] Portion of unrecognized prior service cost associated with future years of service associated with terminated participants.
[4] Portion of unrecognized transition obligation associated with future years of service associated with terminated participants.
[5] The accrued post-retirement cost equals the net of an accumulated value of unfunded accruals of $(6,000) and an accumulated value of prepayment credits of $2,000.

Pursuant to SFAS 106, the $14,000 for granting special termination would be recognized as an expense of the current period. For contract costing purposes, the $14,000 must be amortized over a period of 10 years in accordance with 9904.419–50(e)(2)(i). The curtailment gain for contract costing purposes is $19,160, which is the remaining amount of the curtailment gain not offset against unrecognized prior service cost and unrecognized transition obligation using SFAS 106 methodology, in accordance with 9904.419–50(e)(2)(i). For SFAS 106 purposes, the $19,160 curtailment gain would be recognized as income for the current period. For contract cost purposes, the $19,160 curtailment gain must be amortized over a period of 10 years in accordance with 9904.419–50(e)(2)(i).

(iii) After considering the effects of the special termination benefit loss and the curtailment gain, the contractor demonstrates that its accounting for post-retirement benefit costs is still in balance as required by 9904.419–40(b)(5)(iv) as follows:

| | Contract cost accounting as of December 31 | | | |
|---|---|---|---|---|
| | Before curtailment | Special termination benefits | Curtailment gain | After curtailment |
| Accumulated post-retirement benefit obligation | $257,000 | $14,000 | $(68,000) | $203,000 |
| Fair value of plan assets | (69,000) | | | (69,000) |
| Accumulated value of unfunded accruals | (6,000) | | | (6,000) |
| Accumulated value of prepayment credits | 2,000 | | | 2,000 |
| Unfunded accumulated post-retirement benefit obligation | 184,000 | 14,000 | (68,000) | 130,000 |
| Unrecognized net gain | (44,000) | | | (44,000) |
| Unrecognized prior service cost | 33,000 | | (5,940) | 27,060 |
| Unrecognized transition obligation | 195,000 | | (42,900) | 152,100 |
| Unrecognized special termination benefit loss | | 14,000 | | 14,000 |
| Unrecognized curtailment gain | | | (19,160) | (19,160) |
| Sum of unrecognized amounts | 184,000 | 14,000 | (68,000) | 130,000 |
| Results of 9904.419–40(b)(5)(iv) balance test | Passes | Passes | Passes | Passes |

(2)(i) Assume that immediately after the curtailment of benefits, Contractor M in illustration 9904.419–60(e)(1) purchases insurance from an non-captive insurer at a price of $58,000 to unconditionally settle its obligation for certain post-retirement benefits. The purchase of this insurance reduces the accumulated post-retirement benefit obligation by $50,000 measured using the contractor's established methods and assumptions. Pursuant to SFAS 106, the contractor recognizes that a loss from the settlement of benefits has occurred. For SFAS 106 purposes the

contractor determines the settlement loss as follows:

| | SFAS 106 accounting as of December 31 | | |
|---|---|---|---|
| | Before settlement | Settlement loss | After settlement |
| Accumulated post-retirement benefit obligation | $(203,000) | $50,000 | $(153,000) |
| Fair value of plan assets | 69,000 | (58,000) | 11,000 |
| Funded Status | (134,000) | [1] (8,000) | (142,000) |
| Unrecognized net gain | (44,000) | [2] 10,837 | (33,163) |
| Unrecognized prior service cost | 27,060 | ..... | 27,060 |
| Unrecognized transition obligation | 152,100 | [3](10,837) | 141,263 |
| Pre-paid (accrued) post-retirement benefit cost | 1,160 | (8,000) | (6,840) |

[1] Loss due to cost of settlement in excess of accumulated post-retirement benefit obligation.
[2] Portion of unrecognized transition obligation eliminated by settlement.
[3] Loss due to immediate recognition of a portion of the unrecognized transition obligation.

(ii) Pursuant to 9904.419–50(e)(2)(i), the settlement loss for contract costing purposes is $8,000 using SFAS 106 methodology. For SFAS 106 purposes, the contractor recognizes a current period expense of $8,000 for the settlement loss. For contract cost purposes, the $8,000 settlement loss must be amortized over the next 10 years in accordance with 9904.419–50(e)(2)(i).

(iii) After considering the effects of the settlement, the contractor demonstrates that its accounting for post-retirement benefit costs is still in balance as required by 9904.419–40(b)(5)(iv) as follows:

| | Contract cost accounting as of December 31 | | |
|---|---|---|---|
| | Before settlement | Settlement loss | After settlement |
| Accumulated post-retirement benefit obligation | $203,000 | $(50,000) | $153,000 |
| Fair value of plan assets | (69,000) | 58,000 | (11,000) |
| Accumulated value of unfunded accruals | (6,000) | ..... | (6,000) |
| Accumulated value of prepayment credits | 2,000 | ..... | 2,000 |
| Unfunded accumulated post-retirement benefit obligation | 130,000 | 8,000 | 138,000 |
| Unrecognized prior net gain | (44,000) | 10,837 | (33,163) |
| Unrecognized prior service cost | 27,060 | ..... | 27,060 |
| Unrecognized transition obligation | 152,100 | (10,837) | 141,263 |
| Unrecognized special termination benefit loss | 14,000 | ..... | 14,000 |
| Unrecognized curtailment gain | (19,160) | ..... | (19,160) |
| Unrecognized settlement loss | ..... | 8,000 | 8,000 |
| Sum of unrecognized amounts | 130,000 | 8,000 | 138,000 |
| Results of 9904.419–40(b)(5)(iv) balance test | Passes | Passes | Passes |

(3) Assume that as part of the work force reduction by Contractor M in illustration 9904.419–60(e)(1), a disproportionate share of the employee terminations is attributable to one of its segments. In that case, the contractor must determine the termination benefit loss separately for each segment in accordance with 9904.419–50(c)(2)(i) and 9904.419–50(c)(2)(ii). On the other hand, if the effect is evenly dispersed across some, but not all, of the segments, the contractor may determine the termination benefit loss for the affected segments in the aggregate and allocate the loss among the affected segments by use of an appropriate base such as the number of employees terminated in each segment as part of the workforce reduction.

*(f) Adjustments for segment closings.*

(1) (i) Contractor T has been performing Government contracts subject to this Standard. Upon completion of its current Government contracts, the contractor does not actively seek nor receive any new Government contracts subject to this Standard and therefore a segment closing, as defined by 9904.419–30(b)(6)(iii), has occurred. The accounting of the liabilities and assets for the post-retirement benefits of Segment A for government contract costing purposes immediately before the segment closing is summarized as follows:

| | Value as of 12/31 |
|---|---|
| Accumulated post-retirement benefit obligation: | |
| Retirees receiving benefits | $250,000 |
| Actives—Currently eligible for benefits | 100,00 |

| | Value as of 12/31 |
|---|---|
| Nonforfeitable post-retirement benefit obligation | 350,000 |
| Actives—Not yet eligible for benefits | 400,000 |
| Total | 750,000 |
| Valuation assets: | |
| Fair value of plan assets[1] | (270,000) |
| Accumulated value of unfunded accruals | (150,000) |
| Accumulated value of prepayment credits[2] | ..... |
| Total | 420,000 |
| Unfunded accumulated post-retirement benefit obligation | 330,000 |
| Unfunded nonforfeitable post-retirement benefit obligation[3] | (70,000) |
| Unrecognized net gain | (150,000) |
| Unrecognized prior service cost | 405,000 |
| Unrecognized transition obligation | 75,000 |
| Sum of unrecognized amounts | 330,000 |
| Result of 9904.419–40(b)(5)(iv) balance test | Passes |

[1] In accordance with 9904.419–50(c)(6)(i), the fair value of plan assets allocated to segments exclude the accumulated value of prepayment credits.
[2] In accordance with 9904.419–50(c)(6)(i), the accumulated value of prepayment credits were separately identified and were not allocated to segments.
[3] Nonforfeitable post-retirement benefit obligation of $350,000 less valuation assets of $420,000.

(ii) The contractor must fully recognize a segment closing credit of $70,000, which is measured as the difference of the nonforfeitable post-retirement benefit obligation ($350,000) and the valuation assets ($420,000). The segment closing adjustment credit of $70,000 represents an adjustment to previously determined post-retirement benefit costs in accordance with 9904.419–50(f)(3)(i). The Government's share of the $70,000 must be effected by adjusting contract prices, target costs, or cost ceilings, or by any other suitable technique in accordance with 9904.419–50(f)(4). One way the adjustment could be effected is by a check or other funds transfer from the contractor to the Government.

(2) If Contractor T in illustration 9904.419–60(f)(1) discontinues its operations at Segment W and abandons the facility, a segment closing as defined by 9904.419–30(b)(6)(ii) has occurred. Alternatively, if the operations of Segment W continue but the facility is sold to a third party who is not a successor-in-interest, then a segment closing as defined by 9904.419–30(b)(6)(i) has occurred. In either case, the government's share of the $70,000 credit shall be determined, as outlined in illustration 9904.419–60(f)(1), and credited to the government in accordance with 9904.419–50(f)(4).

(3) Assume that Contractor T in Illustration 9904.419–60(f)(1) sells Segment A to Contractor U, who is a successor-in-interest in the segment's government contracts through a novation agreement of the segment's government contracts. A segment closing as defined by 9904.419–30(b)(6)(i) has occurred. The entire accumulated post-retirement benefit obligation of $750,000 for both active and retired plan participants and all other post-retirement benefit plan values are transferred to the successor-in-interest as part of a sales agreement. Pursuant to 9904.419–50(f)(3)(v)(A), no segment closing adjustment is required. The accounting of the liabilities and assets for the post-retirement benefits of Segment A for government contract costing purposes is summarized immediately before and after the sale as follows:

| | | After | |
|---|---|---|---|
| Before | Original contractor | Original contractor | Successor contractor |
| Accumulated post-retirement benefit obligation: | | | |
| Retirees receiving benefits | $250,000 | ..... | $250,000 |
| Actives—Currently eligible | 100,000 | ..... | 100,000 |
| Nonforfeitable post-retirement benefit obligation | 350,000 | ..... | 350,000 |
| Actives—Not yet eligible | 400,000 | ..... | 400,000 |
| Total | 750,000 | ..... | 750,000 |
| Valuation assets: | | | |
| Fair value of plan assets[1] | (270,000) | ..... | (270,000) |
| Accumulated value of unfunded accruals | (150,000) | ..... | (150,000) |
| Accumulated value of prepayment credits[2] | ..... | ..... | ..... |
| Total | (420,000) | ..... | (420,000) |
| Unfunded accumulated post-retirement benefit obligation | 330,000 | ..... | 330,000 |

| | | After | |
|---|---|---|---|
| Before | Original contractor | Original contractor | Successor contractor |
| Unfunded Nonforfeitable post-retirement benefit obligation [3] | (70,000) | ..... | (70,000) |
| Unrecognized transition obligation | (150,000) | ..... | (150,000) |
| Unrecognized prior service cost | 405,000 | ..... | 405,000 |
| Unrecognized (gain) or loss | 75,000 | ..... | 75,000 |
| Sum of unrecognized amounts | 330,000 | ..... | 330,000 |
| Results of 9904.419–40(b)(5)(iv) balance test | Passes | Passes | Passes |

[1] In accordance with 9904.419–50(c)(6)(i), the fair value of plan assets allocated to segments exclude the accumulated value of prepayment credits.
[2] In accordance with 9904.419–50(c)(6)(i), the accumulated value of prepayment credits were separately identified and were not allocated to segments.
[3] Nonforfeitable post-retirement benefit obligation of $350,000 less valuation assets of $420,000.

(4) (i) Assume that Contractor V transfers only the accumulated post-retirement benefit obligation of $500,000 attributable to active plan participants to Contractor W, the successor-in-interest. The contractor retains the accumulated post-retirement benefit obligation of $250,000 for the retired participants. Pursuant to 9904.419–50(f)(3)(iv) and 9904.419–50(f)(3)(v)(B), the contractor transfers a portion of the fair value of plan assets, accumulated value of unfunded accruals, and accumulated value of prepayment credits to the successor contractor in accordance with 9904.419–50(c)(6)(viii).

(ii) Because the sum of the fair value of plan assets and accumulated value of unfunded accruals is less than the nonforfeitable post-retirement benefit obligation, the full amount of the fair value of plan assets and accumulated value of unfunded accruals is allocated to the nonforfeitable post-retirement benefit obligation. (Note that the accumulated value of prepayment credits is $0.) There is no remaining balance of fair value of plan assets and accumulated value of unfunded accruals to be allocated to the forfeitable post-retirement benefit obligation.

(iii) The contractor transferred 28.5714% ($100,000 ÷ $350,000) of the nonforfeitable post-retirement benefit obligation to the successor contractor and therefore transfers to the successor contractor 28.5714% of the fair value of plan assets ($25,714) and accumulated value of unfunded accruals ($35,714) allocated to the nonforfeitable post-retirement benefit obligation.

(iv) Although the entire forfeitable post-retirement benefit obligation was transferred to the successor contractor, no fair value of plan assets nor accumulated value of unfunded accruals were allocated to the forfeitable post-retirement benefit obligation. Therefore no additional fair value of plan assets nor accumulated value of unfunded accruals is transferred to the successor contractor.

(v) The unfunded accumulated post-retirement benefit obligation transferred to the successor contractor is $438,572, which is 81.9761% ($438,572 ÷$535,000) of the original unfunded accumulated post-retirement benefit obligation. According, the contractor transfers 81.9761% of the unrecognized transition obligation, unrecognized prior service cost, and unrecognized gains and losses to the successor contractor.

(vi)(A) The accounting of the obligations and assets for the post-retirement benefits of Segment A for government contract costing purposes is summarized immediately before and after the sale as follows:

| | Before | After | |
|---|---|---|---|
| | Original contractor | Original contractor | Successor contractor |
| Accumulated post-retirement benefit obligation: | | | |
| Retirees receiving benefits | $250,000 | $250,000 | ..... |
| Actives—Currently eligible | 100,000 | ..... | $100,000 |
| Nonforfeitable post-retirement benefit obligation | 350,000 | 250,000 | 100,000 |
| Actives—Not yet eligible | 400,000 | ..... | 400,000 |
| Total | 750,000 | 250,000 | 500,000 |
| Valuation assets: | | | |
| Fair value of plan assets [1] | (90,000) | (64,286) | (25,714) |
| Accumulated value of unfunded accruals | (125,000) | 89,286) | 35,714) |
| Accumulated value of prepayment credits [2] | ..... | ..... | ..... |
| Total | (215,000) | 153,572 | (61,428) |
| Unfunded accumulated post-retirement benefit obligation | 535,000 | 96,428 | 438,572 |
| Unfunded Nonforfeitable post-retirement benefit obligation [3] | 135,000 | 96,428 | 38,572 |
| Unrecognized transition obligation | (50,000) | (9,012) | (40,988) |
| Unrecognized prior service cost | 410,000 | 73,898 | 336,102 |
| Unrecognized (gain) or loss | 175,000 | 31,542 | 143,458 |

| | Before | After | |
|---|---|---|---|
| | Original contractor | Original contractor | Successor contractor |
| Sum of unrecognized amounts | 535,000 | 96,428 | 438,572 |
| Results of 9904.419–40(b)(5)(iv) balance test | Passes | Passes | Passes |

[1] In accordance with 9904.419–50(c)(6)(i), the fair value of plan assets allocated to segments excludes the accumulated value of prepayment credits.
[2] In accordance with 9904.419–50(c)(6)(i), the accumulated value of prepayment credits were separately identified and were not allocated to segments.
[3] In the ''Before'' column, this is the nonforfeitable post-retirement benefit obligation of $350,000 less valuation assets of $215,000. Amounts shown under ''After'' columns were similarly derived.

(B) The contractor then determines a segment closing adjustment charge of $96,428, which is measured as the difference of the nonforfeitable post-retirement benefit obligation of $250,000 and $153,572, which is the sum of the fair value of assets ($64,286) and the accumulated value of unfunded accruals ($89,286) less any accumulated value of prepayment credits ($0.) The segment closing adjustment charge of $96,428 represents an adjustment to previously determined post-retirement benefit costs in accordance with 9904.419–50(f)(3)(i). The Government's share of the $96,428 must be effected by adjusting contract prices, target costs, or cost ceilings, or by any other suitable technique in accordance with 9904.419–50(f)(4). One way the adjustment could be effected is by a check or other funds transfer from the Government to the contractor. The contractor must also reflect that segment closing adjustment has been effected by increasing the accumulated value of unfunded accruals by $96,428 in accordance with 9904.419–50(f)(3)(vi).

(5) Contractor W in illustration 9904.419–60(f)(4), after completing the transfer to the successor-in-interest, transfers the retained retired participants, and the retained accumulated post-retirement benefit obligation, fair value of plan assets, and all other values attributable to the retained retired participants, to the closed segment's former home office in accordance with 9904.419–50(f)(3)(iii). For government contract costing purposes, the accumulated post-retirement benefit obligation, fair value of plan assets, and all other values attributable to the retained inactive (retired) participants are combined with the records of the home office as follows:

| | Home office | | |
|---|---|---|---|
| | Retained retired participants | Home office participants | Totals |
| Accumulated post-retirement benefit obligation: | | | |
| Retirees receiving benefits | $250,000 | $100,000 | $350,000 |
| Actives—Currently eligible | ..... | 235,000 | 235,000 |
| Nonforfeitable post-retirement benefit obligation | 250,000 | 335,000 | 585,000 |
| Actives—Not yet eligible | ..... | 410,000 | 410,000 |
| Total | 250,000 | 745,000 | 995,000 |
| Valuation assets: | | | |
| Fair value of plan assets [1] | (64,286) | (268,000) | (332,286) |
| Accumulated value of unfunded accruals [2] | (185,714) | (151,000) | (336,714) |
| Accumulated value of prepayment credits [3] | ..... | ..... | ..... |
| Total | (250,000) | (419,000) | (669,000) |
| Unfunded accumulated post-retirement benefit obligation | ..... | 326,000 | 326,000 |
| Unfunded Nonforfeitable post-retirement benefit obligation [4] | ..... | (84,000) | (84,000) |
| Unrecognized transition obligation [5] | ..... | (147,000) | (147,000) |
| Unrecognized prior service cost [6] | ..... | 396,000 | 396,000 |
| Unrecognized (gain) or loss [7] | ..... | 77,000 | 77,000 |
| Sum of unrecognized amounts | ..... | 326,000 | 326,000 |
| Results of 9904.419–40(b)(5)(iv) balance test | Passes | Passes | Passes |

[1] In accordance with subparagraph 9904.419–50(c)(6)(i), the fair value of plan assets allocated to segments excludes the accumulated value of prepayment credits.
[2] The segment closing adjustment charge is effected by increasing the accumulated value of unfunded accruals of $89,286 by the segment closing adjustment of $96,428 in accordance with subparagraph 9904.419-50(f)(3)(vi).
[3] In accordance with 9904.419–50(c)(6)(i), the accumulated value of prepayment credits were separately identified and were not allocated to segments.
[4] In the ''Home Office Participants'' column, this is the nonforfeitable post-retirement benefit obligation of $335,000 less valuation assets of $419,000. Amounts shown under ''Retained Retired Participants'' and ''Total'' columns were similarly derived.
[5] Unrecognized gains and losses for the retained participants have already been fully recognized by the segment closing adjustment.
[6] Unrecognized transition obligation for the retained participants have already been fully recognized by the segment closing adjustment.
[7] Unrecognized past service cost for the retained participants have already been fully recognized by the segment closing adjustment.

(6) Contractor X, after acquiring Segment A as successor-in-interest to Contractor T in illustration 9904.419–60(f)(4), decreases the discount rate assumption from 8.5% to 8.0% to match the discount rate assumption used for its other post-retirement benefit plans. This decrease in the assumed discount rate causes the accumulated post-retirement benefit obligation to increase by $43,000 from $500,000 to $543,000. In accordance with 9904.419–50(f)(3)(v)(C), the $43,000 actuarial loss attributable to the change in the discount rate assumption is recognized by the successor contractor immediately after the acquisition of the segment. An annual gain or loss component of the successor-in-interest's post-retirement benefit cost shall be recognized in accordance with 9904.419–50(b)(2)(vi). There is no other adjustment in the values and records used by the original contractor for government contract costing purposes.

**9904.419–61 Interpretation. [Reserved]**

**9904.419–62 Exemptions.**

None for this Standard.

**9904.419–63 Effective date.**

(a) This Standard is effective as of [90 days after date of publication of the final rule in the **Federal Register**].

(b) This Standard shall be followed by each contractor on or after the start of its next cost accounting period beginning after the receipt of a contract or subcontract to which this Standard is applicable.

**9904.419–64 Transition method.**

(a) *General.* In complying with this Standard 9904.419, contractors must follow the equitable principle that post-retirement benefit costs which have been previously provided for, shall not be redundantly provided for under this Standard. Conversely, post-retirement benefit costs that have not previously been provided for, shall be provided for in accordance with this Standard. The method, or methods, employed to achieve an equitable transition shall be consistent with the provisions of this Standard and shall be approved by the cognizant Federal agency official.

(b) *Change to pay-as-you-go method.* If a contractor, who for Government contracting purposes had accounted for costs of a defined-benefit post-retirement plan on an accrual basis prior to the date this Standard becomes applicable, changes to the pay-as-you-go cost method, the contractor shall account for any unfunded post-retirement benefit costs of prior periods by establishing an accumulated value of unfunded accruals in accordance with 9904.419–50(c)(6)(v). Post-retirement benefit costs calculated under the pay-as-you-go cost method shall be charged against any fair value of plan assets and such accumulated value of unfunded accruals before any post-retirement benefit costs may be allocated to intermediate or final cost objectives.

(c) *Change to accrual accounting.* If a contractor, who for Government contracting purposes had accounted for the costs of a defined-benefit post-retirement plan using the pay-as-you-go cost method prior to the date this Standard becomes applicable, changes to accrual accounting, the contractor shall account for any portion of prior post-retirement benefit costs that are not included in the unrecognized prior service costs, unrecognized gains and losses, or unrecognized transition obligation when this Standard is first applicable to the contractor. Such prior post-retirement benefit costs shall be accounted for as either a supplemental transition obligation or as part of a ''fresh start'' transition obligation, and shall be amortized as specified in paragraph (c)(3) of this subsection:

(1) For each period subsequent to adoption of accrual accounting for SFAS 106, but prior to the date this Standard becomes applicable to the contractor, that the contractor used the pay-as-you-go cost method for Government contracting purposes, the contractor shall establish a supplemental transition obligation. This supplemental transition obligation shall be the accumulated value of such prior post-retirement benefit cost accruals minus the costs determined using the pay-as-you-go cost method. The net result shall be increased at the interest rate as determined by the Secretary of the Treasury pursuant to Public Law 92–41, 85 Stat. 97 during such periods. The supplemental transition obligation shall be subject to the same accounting treatment under this Standard as the transition obligation; or,

(2) Alternatively, if for every period subsequent to adoption of accrual accounting for SFAS 106, but prior to the date this Standard becomes applicable to the contractor, the contractor had used the pay-as-you-go cost method for Government contracting purposes, the contractor may adopt a ''fresh start'' determination of the transition obligation as of the first valuation date after this Standard becomes applicable. In this case, the transition obligation shall equal the accumulated post-retirement benefit obligation less the fair value of plan assets. If the contractor elects to use the ''fresh start'' method, any unrecognized prior service costs or unrecognized gains and losses are subsumed into such redetermined transition obligation.

(3) The supplemental transition obligation or the ''fresh start'' redetermined transition obligation shall be amortized on a straight-line basis over the average remaining service period of active plan participants, except that if all or almost all of the plan participants are inactive, the employer shall use the average remaining life expectancy period of those plan participants.

(d) *Terminal funding.* If a contractor has established, disclosed, and consistently followed a practice of determining and accounting for post-retirement benefit costs in accordance with the terminal funding provisions of 9904.416–50(a)(1)(v)(C), the contractor may continue that practice. Terminal funding shall be treated in the same manner as the pay-as-you-go cost method except that the amortization provisions of 9904.419–40(b)(3)(ii) and 9904.419–50(b)(1) shall not apply.

(e) *Certain inactive participants.* If at the time the contractor first becomes subject to this Standard, the contractor cannot associate some of its inactive plan participants with existing segments (because the segment has been sold, the segment no longer exists, or the necessary data are not readily available), the contractor shall associate such inactive plan participants with the appropriate corporate home office, intermediate home office, or segment in accordance with the contractor's previous cost accounting practice used for Government contract accounting.

(f) *Prior segment accounting.* If prior to the time a contractor is required to use this Standard, the contractor has been calculating post-retirement benefit cost for contract cost purposes using the same accrual accounting methods used for SFAS 106, then:

(1) For a contractor that has been calculating post-retirement benefit cost separately for individual segments, the fair value of plan assets and all other values previously allocated to those segments shall not be changed, or

(2) For a contractor that has been determining the accrual for post-retirement benefit costs on a composite basis and allocating such costs to segments, if an initial allocation of the fair value of plan assets is required by 9904.419–50(c)(6)(i), such initial allocation shall reflect such prior cost determinations and allocations. If the necessary data are readily determinable, the fair value of plan assets to be allocated to each segment shall be the amount contributed by, or on behalf of, the segment, increased by income received on such assets, and decreased

by benefits and expenses paid from such assets. If the data are not readily determinable for certain prior periods, the contractor shall follow the initial asset allocation provisions of 9904.419–50(c)(6)(i)(C) as of the earliest date such data is available.

(g) *Transition illustrations.* Unless otherwise noted, paragraphs (g)(1) through (6) of this subsection address post-retirement benefit costs and transition amounts determined for the first cost accounting period beginning on or after the date this Standard becomes applicable to a contractor. For purposes of these illustrations an expected long-term rate of return of 8% is presumed to be in effect for all periods. The contractors identified for purposes of these illustrations are unrelated to the contractors identified for illustration purposes in 9904.419–60.

(1) Since December 31, 1993 Contractor A has calculated, assigned, and allocated post-retirement benefit costs to its cost-based negotiated Government contracts on an accrual basis. In determining the unfunded accruals for these prior periods pursuant to 9904.419–50(c)(6)(v), the only funding the contractor can recognize is for benefit payments in accordance with 9904.419–50(c)(6)(vii). The value of these past unfunded accruals, increased for interest and decreased for benefits paid by the contractor, is equal to $2 million as of the beginning of the current period. Assume that the contractor must begin using the pay-as-you-go cost method, because the plan fails to meet the criteria set forth at 9904.419–40(a)(1), to account for current and future post-retirement benefit costs. Plan participants receive $500,000 in benefits on the last day of the current period. Using the transition method of paragraph (b) of this section to ensure prior costs are not redundantly provided for, the contractor shall establish an accumulated value of unfunded accruals of $2 million. Since the $2 million is sufficient to provide for the current benefit payments, no post-retirement benefit costs can be allocated to this period. The accumulated value of unfunded accruals shall be carried forward to the next period by adding $160,000 (8% x $2 million) of imputed interest, and subtracting the $500,000 of benefit payments made by the contractor. The accumulated value of unfunded accruals for the next period equals $1,660,000 ($2 million + $160,000 − $500,000).

(2) Prior to becoming subject to this Standard, Contractor B has accounted for its defined-benefit post-retirement plan which meets the requirements of 9904.419–40(a)(1) using the pay-as-you-go cost method for government contract costing purposes. For the first period the contractor becomes subject to this Standard, the contractor must begin to accrue the costs of its post-retirement benefit plan as specified in this Standard. Pursuant to 9904.419–64(c)(1), the contractor may identify any post-retirement benefit cost accruals which have previously been unrecognized in the costs allocated to its cost-based negotiated Government contracts as a supplemental transition obligation.

(i) A comparison of the contractor's SFAS 106 accounting with its contract cost accounting as of the date the contractor first becomes subject to this Standard is as follows:

| | SFAS 106 accounting | Contract cost accounting |
|---|---|---|
| Accumulated post-retirement benefit obligation | ($2,000,000 | ($2,000,000) |
| Fair value of plan assets | ..... | ..... |
| Funded status | (2,000,000) | (2,000,000) |
| Unrecognized net gain | (196,000) | (196,000) |
| Unrecognized prior service cost | 38,600 | 38,600 |
| Unrecognized transition obligation | 1,557,000 | 1,557,000 |
| Unrecognized supplemental transition obligation | ..... | [1] 600,000 |
| Accrued post-retirement benefit cost | (600,000) | ..... |

[1] The supplemental transition obligation is amortized over 17 years which is the average remaining service period of active plan participants of this post-retirement benefit plan.

(ii) Note that if the contractor had cost-based negotiated Government contracts only for some of the prior periods since adopting SFAS 106 for financial statement purposes, only prior accruals for those periods when it did have such contracts can be used to establish the initial amount of the supplemental transition obligation in accordance with 9904.419–64(c)(1).

(3) Assume that Contractor B in illustration 9904.419–64(g)(2) had cost-based negotiated Government contracts for every period since adopting SFAS 106 and had used the pay-as-you-go cost method. The contractor could elect to redetermine the transition obligation using the so-called ''fresh start'' alternative in accordance with 9904.419–64(c)(2).

(i) In this case, a comparison of the contractor's SFAS 106 accounting with its contract cost accounting as of the date the contractor first becomes subject to this Standard is as follows:

| | SFAS 106 accounting | Contract cost accounting |
|---|---|---|
| Accumulated post-retirement benefit obligation | ($2,000,000 | ($2,000,000) |
| Fair value of plan assets | ..... | ..... |
| Funded status | (2,000,000) | (2,000,000) |
| Unrecognized net gain | (196,000) | n/a |
| Unrecognized prior service cost | 38,600 | n/a |
| Unrecognized transition obligation | 1,557,000 | [1] 2,000,000 |

| | SFAS 106 accounting | Contract cost accounting |
|---|---|---|
| Accrued post-retirement benefit cost | (600,000) | |

[1] The ''fresh-start'' transition obligation is amortized over 17 years which is the average remaining service period of active plan participants of this post-retirement benefit plan.

(ii) Note that if the contractor did not have cost-based negotiated Government contracts for all prior periods since adopting SFAS 106 for financial statement purposes, the contractor could not have elected to use the ''fresh start'' approach of 9904.419–64(c)(2). Also note that the $2 million fresh start transition obligation equals the sum of the SFAS 106 $38,600 unrecognized prior service cost, $1,557,400 unrecognized transition obligation, and the $600,000 accrued post-retirement benefit cost less the $196,000 unrecognized net gain.

(4) Since 1983, Contractor C has had an established practice of terminal funding for determining the costs of its post-retirement benefit plan in accordance with 9904.416–50(a)(1)(v)(C). During the first period the contractor is subject to this Standard, the contractor pays a $235,000 net single premium for non-participating insurance contracts to irrevocably settle its obligation to provide life insurance for its retiring plan participants. Pursuant to paragraph (d) of this section, the contractor may continue its established practice of terminal funding and assign the entire $235,000 lump sum settlement payment as the post-retirement benefit cost for the period. Conversely, if the contractor had not established terminal funding as its cost accounting practice prior to becoming subject to this Standard, the $235,000 single premium payment would have to be amortized over a period of 15 years for purposes of assigning the cost to periods in accordance with 9904.419–40(b)(3)(ii) and 9904.419–50(b)(1).

(5) When Contractor D became subject to this Standard, the contractor reviewed its personnel and benefits records to determine in which segment each inactive plan participant was last employed. Of the contractor's 600 inactive plan participants, 98 had been employed in and retired from a commercial segment under Division A that had been shut down and abandoned several years before. There were another 23 inactive plan participants who could not be associated with an existing segment because their employment and benefit records did not provide sufficient information. Pursuant to paragraph (e) of this section, after the contractor associated the remaining 479 inactive participants with existing segments, the 98 who were employed in the segment that had been discontinued were associated with the home office for Division A. Likewise, the contractor associated the other 23 inactives, who could not be associated with any segment, with the corporate home office. Alternatively, if the contractor had an established practice of associating the costs all inactive plan participants no longer associated with operational segments to the corporate home office, the contractor could continue that established practice in accordance with paragraph (e) of this section.

(6) Since 1993, Contractor E has measured and assigned post-retirement benefit costs in accordance with SFAS 106 for both financial accounting and contract cost accounting purposes. The contractor elected to amortize the transition obligation using the delayed recognition provisions of paragraphs 112 and 113 of SFAS 106. Since 1993, the contractor has funded its assigned post-retirement benefit costs in accordance with relevant Federal regulations. The post-retirement benefit cost was measured for the corporation as a whole and allocated to segments in accordance with Cost Accounting Standard 9904.403. Funding agency records and actuarial valuation reports are available for all years. However, reliable records of benefit payments by segment are available only for 1995 and later years. Pursuant to paragraph (f)(2) of this section, the contractor shall initially allocate a share of the undivided fair value of plan assets to each of its segments based on the accumulated post-retirement benefit obligation of each segment starting in 1995 in accordance with 9904.419–50(c)(6)(i)(C). The fair value of plan assets of each segment shall then be brought forward based on contributions, benefit payments, and investment earnings and expenses in accordance with 9904.419–50(c)(6)(i)(D).

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