DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PAC 730.3.B.08/2007-01 May 1, 2007
07-PAC-013(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on the Impact of the Pension Protection Act of 2006

Summary

The Pension Protection Act of 2006 (PPA), signed into law on August 17, 2006, will likely increase contractor contributions to their defined benefit pension plans beginning CY 2008. However, contractors are required to continue to comply with CAS 412 and CAS 413 for Government contract costing purposes. Auditors should question any proposed pension costs in excess of the amounts calculated in compliance with CAS 412 and 413.

Background

The PPA was enacted to ensure adequate funding of pension plans and to strengthen the federal pension insurance system. The PPA is likely to result in increased funding of defined benefit pension plans primarily due to lower interest rate assumptions and a shorter amortization period than those prescribed by CAS. The PPA requires the use of corporate bond rates of return in measuring the pension obligation, while CAS requires the use of a long-term average rate of return contractors are expected to experience. Because the PPA-required corporate bond rates are expected to be lower than the CAS required rate of return, a higher pension obligation will likely be computed under the PPA. A shorter amortization period used under the PPA will also cause pension contribution increases. The PPA requires that the unfunded actuarial liability and actuarial gains and losses be amortized over 7 years, while CAS amortization periods are 10-30 years for the unfunded actuarial liability and 15 years for actuarial gains and losses.

DoD Policy

The Director, Defense Procurement and Acquisition Policy (DPAP), issued DoD policy addressing the impact of the PPA on forward pricing (see Enclosure). The key provisions of the DoD policy are that pension cost priced into contracts shall continue to comply with CAS 412 and 413 and that Contracting Officers shall not negotiate any increase in contract price or include a re-opener clause that would allow for a later adjustment for pension costs in anticipation of a revision to CAS 412.

Guidance

PPA required pension contributions are expected to occur beginning CY 2008. FAOs cognizant of audits of contractor defined benefit pension plans should ensure that contractors continue to estimate and claim pension costs in accordance with the CAS. If contractor pension costs included in forward pricing rate proposals have significantly increased from prior years, the auditor should obtain and evaluate the reasons for the increase from the contractor. Likewise, audits of CAS 412 and 413 compliance and audits of incurred pension costs should include the evaluation of any changes in the contractor's actuarial assumptions and amortization periods from prior years. In all cases, any pension costs proposed in excess of the amount calculated in compliance with CAS 412 and CAS 413 should be questioned.

PPA required pension contributions in excess of CAS compliant pension costs will represent prepayment credits, as provided in CAS 412.50(a)(4). CAS provides that prepayment credits are not reimbursed in the period in which the contribution is made, but instead, are reimbursed in future accounting periods in which the credits are applied to fund the pension costs of the periods.

FAOs cognizant of audits of contractor segments that receive allocations of defined benefit pension costs from their home office should request an assist audit from the cognizant home office auditors if the contractor's segment proposals include increased defined benefit pension costs.

If FAO personnel have any questions or concerns on this subject, they should contact regional personnel. If regional personnel have any questions, they should contact Accounting and Cost Principles Division, at (703) 767-3250.

/Signed/
Kenneth J. Saccoccia
Assistant Director
Policy and Plans

Enclosure:
DPAP Memorandum, dated December 22, 2006

DISTRIBUTION: C

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

ACQUISITION,
TECHNOLOGY
AND LOGISTICS

DEC 22 2006

MEMORANDUM FOR DEPUTY ASSISTANT SECRETARY OF THE ARMY (POLICY AND PROCUREMENT), ASA (ALT)
DEPUTY ASSISTANT SECRETARY OF THE NAVY (ACQUISITION MANAGEMENT), ASN (RDA)
DEPUTY ASSISTANT SECRETARY OF THE AIR FORCE (ACQUISITON), SAF/AQ
DIRECTORS OF DEFENSE AGENCIES

SUBJECT: Impact of the Pension Protection Act of 2006 on Forward Pricing

The recently passed Pension Protection Act (PPA) of 2006 may require contractors to significantly change the funding of their defined benefit pension plans. Starting in 2006, the PPA will permit companies to voluntarily increase their pension contributions; starting in 2008, the PPA may cause contractors to significantly increase their required minimum pension contribution for tax purposes. However, such funding changes will not necessarily result in increased costs on negotiated contracts (including ACO negotiated/determined Forward Pricing Rates (FPRs)). In reviewing and negotiating any proposed increases in pension costs related to the PPA in negotiated prices and FPRs, contracting officers shall comply with the following policy:

1. Proposed Increased Pension Costs Using Current CAS Rules

The application of the PPA changes are complex and will require review by DoD pension and cost accounting experts. For example, contractors may state that pension cost increases are due to the increased recognition of pension cost in the current year that would have been deferred to future years as assignable cost deficits but for the PPA. When contractors propose increased pension costs based on the current Cost Accounting Standards (CAS) and the PPA, contracting officers shall contact their cognizant Administrative Contracting Officer (ACO) and/or Defense Contract Audit Agency (DCAA) auditor for assistance in reviewing these costs before negotiating the contract price.

2. Proposed Increased Pension Costs in Anticipation of Changes to the CAS

Contracting officers shall not (a) negotiate any increase in contract prices or FPRs related to a potential CAS change resulting from the PPA, nor (b) include re-opener clauses addressing such costs.

For contracts that are subject to full CAS coverage, any changes to CAS 412 and 413 promulgated by the CAS Board as a result of the PPA may entitle the contractor to an equitable adjustment for those contracts as of the effective date of any such amendment or other guidance issued by the CAS Board.

For contracts that are subject only to modified CAS coverage and contracts that are not covered by CAS, FAR 52.216-7, "Allowable Cost and Payment" clause, determines the allowability of pension costs and locks the contract into the version of FAR 31.2 in effect at the date of contract award. Consequently, contractors with contracts awarded prior to any revision to CAS 412 will be obligated by FAR 31.205-6(j)(2) to continue to apply the (pre-revision) version of CAS 412 in effect at the time of contract award. Any change to CAS 412 will not impact these contracts. They will be subject to the CAS 412 in effect at the time of contract award.

In conclusion, contracting officers shall not include in the contract price or recognize as allowable any increased pension costs for anticipated changes to the CAS into any contract or FPR, or include a re-opener clause that would allow adjustment to the contract at a later date. To do so would result in over-recovery of costs by the contractor.

3. Special Rules for Plans of Certain Government Contractors

Under the PPA, contractors that meet the requirements of section 106(c), "Eligible Government Contractor Plan Defined," are subject to a mandatory delayed implementation of Title I of the PPA. Specifically, section 106 of the Act provides:

> *(a) General Rule- Except as provided in this section, if a plan is an eligible government contractor plan, this subtitle and subtitle B shall not apply to plan years beginning before the earliest of--*
> *(1) the first plan year for which the plan ceases to be an eligible government contractor plan,*
> *(2) the effective date of the Cost Accounting Standards Pension Harmonization Rule, or*
> *(3) January 1, 2011.*
>
> *(b) . . .*
>
> *(c) Eligible Government Contractor Plan Defined- For purposes of this section, a plan shall be treated as an eligible government contractor plan if it is maintained by a corporation or a member of the same affiliated group (as defined by section 1504(a) of the Internal Revenue Code of 1986), whose primary source of revenue is derived from business performed under contracts with the United States that are subject to the Federal Acquisition*

Regulations (Chapter 1 of Title 48, C.F.R.) and that are also subject to the Defense Federal Acquisition Regulation Supplement (Chapter 2 of Title 48, C.F.R.), and whose revenue derived from such business in the previous fiscal year exceeded $5,000,000,000, and whose pension plan costs that are assignable under those contracts are subject to sections 412 and 413 of the Cost Accounting Standards (48 C.F.R. 9904.412 and 9904.413).

Thus, proposed costs, including forward pricing rate proposals, submitted by contractors maintaining Eligible Government Contractor Plans should not include any amounts resulting from the PPA revised minimum funding standards, such as seven year amortization for funding shortfalls, interest rate assumption based upon corporate bond rates of return, or any other revisions contained in Title I of the Act.

In summary, if the contractor proposes increased pension costs as a result of the PPA, the Contracting Officer should consult with the cognizant ACO and auditor before determining whether to include any proposed costs relating to the PPA in the contract price or FPRs.

If you require additional information, my point of contact for this memorandum is Mr. John McPherson, Senior Procurement Analyst, who can be reached at 703-602-0296 or via e-mail at john.mcpherson@osd.mil.

Shay D. Assad
Director, Defense Procurement
and Acquisition Policy