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How to start this?

Let's face it—most Americans don't care about pension costs. That is to say, they care very much about *their own pensions*, but not so much about other peoples' pensions. And almost nobody cares about cost accounting issues associated with pensions.

Even in our small world of government contracting, almost nobody wants to talk about pensions. In fact, let us go so far as to assert that the number of government contract cost accounting experts—the gray-haired CAS gurus—who feel comfortable discussing the nuances of CAS 412 and 413 can be numbered on two hands. Hell, our Principal Consultant has participated in CAS 413-related litigation before the Court of Federal Claims, and even he has to run back to the CAS and to review court cases before being able to confidently discuss some of the issues.

Yes, it's *that* complex.

And it's *that* boring, at least to most folks.

So our challenge today is to write about a **recent GAO report**, issued to Congress, which discusses pension matters within the Defense industrial base, without putting our readership into a coma. The GAO report is entitled, "PENSION COSTS ON DOD CONTRACTS:

Additional Guidance Needed to Ensure Costs are Consistent and Reasonable." Yeah, with a catchy title like that, we're sure all the Senators and staffers are going to be all over it like white on rice. Dan Brown should be worried it's going to displace his **upcoming next installment** of the adventures of Robert Langdon from the bestseller lists.

But before we delve into the GAO best-seller, let's remind our readers that **we've ventured** onto the thin ice of this issue before. So if you're a long-time reader, we expect you're up to speed on issues associated with defined benefit pension plans and—more importantly—the variety of issues associated with recent "harmonization" revisions to Cost Accounting Standards 412 and 413 necessitated by the Pension Protection Act of 2006. If you need a refresher, trying searching for "pension" using the site search feature.

The GAO report is interesting reading for those few gray-haired CAS gurus who have to deal with the various issues. It's an important topic for a number of reasons, not the least of which is that some of the largest defense contractors have been mired in litigation over their pension plans for a number of years. The GAO report notes that, for defense contractors that have defined benefit pension plans subject to CAS 412/413, measured pension costs will start to increase starting in 2014, driven by the "harmonization" revisions to the Standards. It also asserts that the CAS Board failed to carry forward aspects of harmonization into the segment closing provisions of CAS 413. The report asserts that DOD guidance regarding inclusion of defined benefit pension plan costs into forward pricing rate proposals needs more specificity.

The GAO report is actually a pretty good primer for those interested in getting more knowledge of the subject. That's as much as we're going to say about that.

But we do want to discuss what GAO has to say about oversight and audits of defense contractors' pension costs.

According to GAO, DOD "relies on centralized expertise for management and oversight of defined benefit pensions." GAO wrote—

The corporate-level contracting officer has two primary sources of technical expertise available to assist in determining that the contractor's CAS pension costs meet CAS and FAR requirements that they be allowable, allocable, reasonable, and compliant: the DCMA CIPR

Center and auditors from DCAA. … The CIPR Center represents a key element in DOD's oversight process, giving recognition to the complexity and highly technical nature of defined benefit pension plans. As DOD's centralized source of actuarial expertise, it advises DCMA contracting officers on pensions as well as insurance, including review of forward pricing proposals. The CIPR Center assesses the reasonableness of actuarial assumptions, including the discount rates used to calculate liabilities. It also provides an independent measurement for projected pension costs. …

DCAA auditors at the contractor's corporate office are responsible for reviewing other aspects of proposed pension forward pricing, such as previous CAS pension cost estimates to assess how close they were to actual CAS pension costs for those periods. DCAA employs technical specialists who provide auditors with additional support on pension issues. DCAA audits may question costs that they identify as not allowable, allocable or reasonable, which the contracting officer may incorporate into negotiations with the contractor. For example, DCAA audits have questioned costs in forward pricing proposals because estimated CAS pension costs were higher than the contractor's historical cost trends or the calculation methods were not compliant with CAS.

The problem with the current DOD oversight regime, according to GAO, is that they "do not address reasonableness of value of defined benefit pension plans." This means that—

DOD's oversight processes do not clearly assign responsibility for assessing the reasonableness of the value of pension benefits to plan participants, focusing instead on the reasonableness of actuarial assumptions or fringe benefits as a whole.

According to GAO, the fundamental flaw in this approach is that, under CAS, the amount of pension costs measured in any particular year may not equate to the real value to the employees. GAO wrote—

Auditors are instructed to review fringe benefit costs as a whole when determining their reasonableness, but CAS costs for defined benefit pensions are an imperfect measure of the value of pension benefits participants earned in a year as part of their total compensation. Multiple factors drive CAS pension costs. For example, the pension cost could be zero in a given year due to strong asset returns, and this pension cost would not capture any of the value of the benefits earned that year by employees. Conversely, the pension cost could be higher in a given year than the value of the benefits earned that year by employees as a result of actuarial losses. While they may be aware of the CAS costs of defined benefit pensions, auditors do not know the value of these benefits to an employee in a given year. They lack guidance on how to measure this value (containing, for example, acceptable methodologies, assumptions, or data sources), and therefore are unable to get a complete picture of the reasonableness of total compensation for contractor employees.

Neither the CIPR Center nor DCAA's compensation team currently assess the reasonableness of benefits offered through defined benefit plans.

Consequently, GAO recommended that DCAA start evaluating the reasonableness of employees' compensation stemming from defined benefit pension plans. Yeah, you read that correctly. The audit agency that currently has a backlog of some 25,000 unperformed audits of contractors' proposals to establish final billing rates should begin evaluating the reasonableness of the value of defined benefit plans as an individual element of compensation.

Even GAO thought that was a bit of a challenge throw at DCAA. It wrote—

Accurately applying the cost of a defined benefit pension to an individual employee's total compensation package is challenging due to the complexity and annual volatility of costs even if the value of the ultimate benefit does not change. DCAA compensation team officials noted that it is not clear how costs of a defined benefit plan should be evaluated. In addition, they lack current market survey data for defined benefit plans, and team officials noted that companies participating in these surveys do not consistently calculate and report their compensation costs.

But that didn't stop GAO from making the recommendation.

And it didn't stop the Honorable Richard Ginman, Director of Defense Procurement and Acquisition Policy, from agreeing to the recommendation. He wrote—

Concur. DCAA will be responsible for evaluating the reasonableness of pension plans offered by contractors. DCAA will review its current policy to ensure it assesses the value of benefits earned by participants. … If an initial review of the pension plan offered by the contractor indicates a potential for unreasonable compensation, the [DCAA] policy will require an evaluation of other parts of compensation to determine if total compensation is unreasonable as required by FAR 31.205-6(b)(2). … DCAA will reassess its guidance covering the evaluation of defined benefit pension plans as part of the assessment of reasonableness of executive compensation.

Based on our reading of the GAO report, it's clear that DOD is starting to react (more than six years too late) to the specter of increased contractor pension costs. The fact that their interest in the increasing pension costs comes at a time of increased budget pressures on the Defense Department is purely coincidental, we're sure.

So if you are one of the "lucky" contractors that has a defined benefit pension plan, you should expect DCAA to start nosing around, smelling for "unreasonable" benefit levels. Exactly how the auditors will evaluate reasonableness of unclaimed costs, or of costs other than those measured by CAS, remains to be seen.

And if you're one of the "lucky" auditors who gets assigned to evaluate the reasonableness of a contractor's defined pension plan, you should expect contractors to push back a little bit. For instance, we suspect contractors might ask you what right you have to audit a cost that they haven't claimed, or a cost that's different from that measured by CAS.

And we think some smart-ass contractor is going to suggest your time is better spent catching up on all those unperformed audits, rather than tackling new assignments that are likely not to result in large amounts of questioned costs.

P.S. We were interested to note that DPAP now has the authority to establish DCAA audit policy on behalf of the audit agency. The last time we checked, DCAA reported directly to the Defense Comptroller and not to the USD (A,T&L). Perhaps there was a reorg and nobody told DCAA Director Fitzgerald?