

## SELECTED AREAS OF COST

### Chapter 53 – Pension Costs

#### Authoritative Sources

[48 CFR 9904.412](#) (CAS 412) Composition and Measurement of Pension Costs

[48 CFR 9904.413](#) (CAS 413) Adjustment and Allocation of Pension Costs

[FAR 31.205-6\(j\)\(1\)](#) Pension costs

[FAR 31.205-6\(j\)\(2\)](#) Defined-benefit pension plans

[FAR 31.205-6\(j\)\(3\)](#) Pension adjustments and reversions

[FAR 31.205-6\(j\)\(4\)](#) Defined-contribution pension plans

[FAR 31.205-6\(j\)\(5\)](#) Pension plans using the pay-as-you-go cost method

[FAR 31.205-6\(j\)\(6\)](#) Early retirement incentives

[FAR 52.216-7](#) Allowable Cost and Payment

[FAR 52.232-16](#) Progress Payment

[FAR 52.215-15](#) Pension Adjustment and Asset Reversions

A pension plan is a type of deferred compensation that provides benefit payments to participants after their retirement. Pension plans can also provide disability, death, and survivor benefits.

To be classified as a pension plan, the future benefit payments must be paid for life or be payable for life at the option of the employee. The FAR 31.205-6(j) cost principle also covers profit sharing, savings, and similar plans as long as the plan meets the FAR 31.001 definition of a [pension plan](#).

Although certain [Employee Stock Option Plans](#) (ESOPs) may meet the definition of a pension plan, all ESOPs are now subject to a [different set of CAS allocability and FAR allowability criteria](#). See Guidebook Chapter 23, Employee Stock Ownership Plans.

This chapter addresses the following topics:

53-01 General information

53-02 FAR requirements applicable to all pension plans

53-03 Defined-contribution pension plan allowability requirements and audit considerations

53-04 Defined-benefit pension plan allowability requirements and audit considerations

#### General Audit Guidelines

Pensions are an element of employee compensation. When the costs are properly measured, assigned, funded, and allocated, they are generally allowable subject to the FAR 31.205-6(j)(1), (2), (3), (4), and (6) limitations.

CAS 412-30(a) and 413-30(a) provide the definitions that are applicable to pension accounting. Auditors need to exercise due care to appropriately use these terms in the audit working papers and report descriptions.

FAR 31.205-6(j)(1) specifically incorporates CAS 412 and 413, in their entirety, into the requirements for all [FAR 31.2 covered contracts](#). As a result, for contract costing purposes, all contractors must measure, assign, fund, and allocate pension costs in accordance with CAS 412 and 413.

Audit guidance for the CAS 412 and 413 measurement, assignment, funding, and allocation requirements is provided in CAM 8-412 and 8-413. This chapter focuses on the other FAR limitations.

### **53-01 General information**

Pension plans are normally segregated into two types: [defined-contribution](#) and [defined-benefit](#). CAM 8-412.1a. describes the characteristics and the cost accounting methods required for each type of pension plan. The FAR allowability and billing limitations that are applicable to all pension plans are described in 53-02. Specific FAR limitations for defined-contribution and defined-benefit plans are described in 53-03 and 53-04, respectively.

A pension plan will have a formal written document describing the details of the plan. The employer will normally prepare information handbooks or change announcements for employees that explain the major components or any significant revisions of the plan. These handbooks and publications will normally summarize (i) the conditions under which the entitlement to a pension benefit is earned, (ii) the amount of the future benefit payments, and (iii) the timing of those payments.

Although plans are normally classified as either defined-contribution or defined-benefit pension plans, each plan can use different methods and strategies for accumulating and investing pension plan contributions. For example, plans can be [insured](#) or [trusteed](#) or may provide a combination of these investment approaches. Pension plans can also provide differing levels of employer responsibility for funding the resulting pension benefit. For example, a benefit can be provided on a [contributory](#) or [noncontributory](#) basis. Accordingly, even though certain accounting and allowability requirements are dependent on whether the benefit is provided through a defined-contribution or defined-benefit plan, each plan will have its own terms, conditions, and circumstances that can affect the accumulation of pension plan assets, the computation of the annual pension costs, and/or the related value of the future benefit payments.

Most pension plans are submitted to the Internal Revenue Service (IRS) for approval. Generally, the IRS will issue a favorable determination letter if the plan meets certain qualifications. A plan that satisfies the requirements of section 401(a) of the Internal Revenue Code (IRC) is considered to be a qualified plan. From a tax accounting perspective, the use of a qualified pension plan is beneficial because (i) the sponsor is

entitled to claim the current year contributions to the plan as a deduction, and (ii) the plan participants are not required to claim the deferred benefits as income until the benefits are actually paid out. The major requirements of a qualified plan include:

- the employer's contributions to the plan must be irrevocably funded;
- the plan must be intended to be a permanent plan and must be in writing and communicated to the employees; and
- the plan must not discriminate either in contributions or benefits in favor of officers, supervisors or highly compensated employees.

The IRS approval of a [qualified pension plan](#) does not mean the costs in the pension plan are approved, but the pension plan has met certain [IRS established criteria](#) for a plan. However, under CAS 412, the accrual basis of accounting and an acceptable actuarial cost must be used for all qualified defined benefit pension plans. Where a Disclosure Statement is required, the name, type, and qualification status of each pension plan is described at Disclosure Statement Part VII, Items 7.1.0 and 7.1.1.

## **53-02 FAR requirements applicable to all pension plans**

Subparagraph FAR 31.205-6(j)(1) incorporates the CAS 412 and 413 requirements, in their entirety, into the FAR requirements for all contracts negotiated on the basis of cost. In general, CAS 412 provides the requirements for the measurement, assignment, and funding of pension costs. CAS 413 provides additional requirements for (i) measuring actuarially computed pension costs, and (ii) where necessary, adjusting certain types of previously-determined pension costs for certain extraordinary events.

CAS 413 also addresses the allocation of pension costs from a pension plan to the segments of an organization. For fully covered CAS contracts, CAS 418 provides the requirements that generally control the allocation of [business unit](#) costs, including pension costs, to final cost objectives. For modified-CAS covered and exempt contracts, FAR 31.203 Indirect Costs is the controlling requirement for the allocation of indirect costs to contracts and other final cost objectives.

### **53-02.1 FAR 31.205-6(j) general allowability requirements**

Subparagraph FAR 31.205-6(j)(1) also identifies the following allowability requirements that are applicable to all pension plans:

- The pension payments must be paid pursuant to an agreement or based on the terms of an [established plan](#);
- The [costs of changes](#) in pension plans are unallowable if the changes are discriminatory or inconsistently applied;

- Except for early retirement incentives, and with respect to benefits provided through a pension plan and paid from the pension trust, one-time only pension supplements that are not available to all [pension plan participants](#) are [unallowable](#); and
- Cost-of-living adjustments under a consistently followed practice are [allowable](#).

FAR 31.205-6(j)(2) and (4) further identify two other circumstances where the resulting pension costs or payments are allowable and assignable under certain conditions:

- a plan is terminated, the allowability of any cost paid to indemnify the Pension Benefit Guaranty Corporation is considered on a [case-by-case basis](#).
- Current period contributions to a pension plan in excess of the CAS 412 assignable pension costs are not currently allowable; however, the excess amount is referred to as a prepayment credit; this credit can be used to fund CAS 412 assignable [costs in future periods](#).

Pension costs are also a component of overall employee compensation. Accordingly, the FAR 31.205-6(a) General allowability requirements are applicable.

### **53-02.2 FAR 31.205-6(j)(6) limitations on early retirement incentives**

Early retirement incentives are payments offered to employees to encourage eligible employees to retire. The incentive offers are normally targeted to achieve specific work force reductions and cost savings.

The incentive payments can be provided as (i) lump-sum payments, and/or (ii) increased future pension benefits that are paid from the pension trust (e.g., the award of two additional years of service for use in computing the employee's pension benefit). Regardless of the form of an early retirement incentive payment, the following FAR 31.205-6(j)(6) limitations apply:

- the incentive offers must be made under the terms and conditions of an [early retirement incentive plan](#),
- the resulting costs are only allowable if paid to [active employees](#), and
- the present value of the total incentives awarded to an employee cannot exceed his or her [annual salary](#).

Under FAR 31.205-6(j)(6)(i), the costs of the early retirement incentives must also be measured, assigned, and allocated in accordance with established accounting practices for pension costs.

### **53-02.3 FAR 31.205-6(b) Reasonableness of employee compensation**

A comparison of the ratios of the pension benefits or the costs of the pension benefits provided by a contractor plan to the total basic payroll of participants, to similarly calculated ratios for comparable companies, can provide a yardstick measurement of the overall reasonableness of the costs of a plan. While this type of analytical test is not conclusive, it can provide an indicator that the contractor may warrant a more thorough analysis of the overall reasonableness of employee compensation.

### **53-02.4 Pension billing requirement under certain payment clauses**

Unpaid quarterly contributions must be excluded from certain contract billings. Specifically, under the FAR 52.232-16 Progress Payment and FAR 52.216-7 Allowable Cost clauses, when a contractor does not, at a minimum, make quarterly payments to the pension plan for the accrued quarterly pension expense, then the related pension costs must be excluded from the contract billings. The contractor has until 30 days after the applicable quarter end to make the prorata quarterly pension contribution.

The contractor's voluntary billing exclusions, or the DCAA recommended downward adjustment of contractor billings for unpaid quarterly pension contributions, should continue until the past due quarterly pension contribution installment(s) are paid. These payment clause billing limitations apply to all pension plans, including profit sharing, ESOPs, and any other plan that meets the FAR 31.001 definition of a pension plan. If the contractor has accumulated prepayment credits, then the required quarterly funding would be satisfied when the contractor (i) timely applies a portion of the prepayment credit to make the required quarterly contribution, and (ii) appropriately excludes any used prepayment credits from the annual earnings adjustment as of the date that the credit is used in lieu of the required quarterly contribution.

## **53-03 Defined-contribution pension plan allowability requirements and audit considerations**

Under FAR 31.205-6(j)(4)(i), the allowable defined-contribution pension cost is the net contribution required less any dividends and other credits. This requirement is consistent with the applicable CAS 412-40(a)(2) measurement requirements. For determining the amount of the allocable and allowable pension costs, the adjustment for dividends and other credits includes all forfeiture credits and refunds realized during that cost accounting period.

To be allowable, the subject pension costs also must be funded by the time set for filing the Federal income tax return, including any permissible extensions. This FAR 31.205-6(j)(1)(i) requirement is consistent with the CAS 412-50(d)(4) requirement.

However, if certain prior year assignable costs were not funded pursuant to an Employee Retirement Income Security Act of 1974 (ERISA) waiver, those costs may be allowed in the current period if the funding of those costs is made based on the terms and conditions of the ERISA. Otherwise, only the current period's measured pension costs are assignable and allowable, provided the amounts are funded by the corresponding tax filing date, including permissible extensions.

### **53-04 Defined-benefit pension plan allowability requirements and audit considerations for funded defined benefit plans**

The FAR 31.205-6(j)(2) and (3) requirements described below do not impact nonqualified defined-benefit pension plans that use the [Pay-As-Go-Method](#). Under FAR 31.205-6(j)(5), the cost of nonqualified defined-benefit pension plans accounted for under the Pay-As-You-Go method are allowable to the extent that they are not otherwise unallowable. All other defined-benefit pension plans must be either fully or partially funded and are subject to the FAR limitations and audit considerations described below.

#### **53-04.1 FAR 31.205-6(j)(2) allowability requirements for funded defined-benefit pension plans**

Subparagraph FAR 31.205-6(j)(2) includes two additional allowability requirements for funded defined-benefit pension plans:

- Any [increased pension costs](#) caused by a contractor delay in funding of a pension contribution beyond 30 days after each quarter of an applicable cost accounting period are unallowable. See Section 53-04.2 below.
- Any increased costs resulting from an unauthorized withdrawal and [transfer](#) of pension assets to another employee benefit plan or account are unallowable. Specifically, FAR 31.205-6(j)(2)(v) requires an [advanced agreement](#) for such a transfer of pension fund assets to another post-retirement benefit fund or account. The purpose for the required agreement is to ensure that the future increases of pension costs to the Government are offset by a corresponding reduction of future post-retirement benefit costs. Furthermore, transfer made without an advanced agreement will also be treated as a withdrawal of pension funds subject to FAR 31.205-6(j)(3) requirement of the contractor to make a refund or give an equitable credit to the Government for its equitable share of the gross amount withdrawn.

These additional FAR 31.205-6(j)(2) requirements apply only to funded defined-benefit pension plans and are in addition to the requirements described in 53.02.

**53-04.2 FAR 31.205-6(j)(2)(iii) requirement for quarterly contributions to funded defined-benefit pension plans**

A funded defined-benefit pension plan is a plan that is not accounted for under the Pay-As-You-Go method. For funded defined-benefit pension plans, the assignable pension costs for a given cost accounting period must be (i) fully funded for qualified defined-benefit pension plans, or (ii) partially funded for nonqualified defined-benefit pension plans. Under CAS 412-50(d), which is incorporated into the FAR allowability requirement by FAR 31.205-6(j)(1), the required funding must be accomplished, at a minimum, by the corporate tax filing date for the applicable period, including permissible extensions. Any portion of the assignable costs for the period that is not funded by this date is unallowable. Furthermore, under FAR 31.205-6(j)(2)(i)(A) and (B), an assigned but unfunded pension cost is also unallowable in any subsequent cost accounting periods (unless the prior year unfunded amount was pursuant to a waiver granted under the provisions of ERISA, see CAM 8-412.2b(1)).

However, for funded defined-benefit pension plans, FAR 31.205-6(j)(2)(iii) disallows any increases to future costs that would result from any delay in funding the assignable pension costs beyond 30 days after the end of the [quarter](#).

When a required quarterly contribution is not paid within 30 days of the end of the quarter, from an actuarial perspective, there is an opportunity loss for the pension trust. Specifically, the pension trust has lost the opportunity to make the investment returns that would have been earned had the delayed contribution been made on a timely basis. The actuary should separately identify this opportunity cost by calculating a separate actuarial loss. The computation of this increased cost and the resulting actuarial loss should be based on the contractor's established actuarial methods and rates. This actuarial loss is measured on an annual basis and, therefore, the impact of a delayed quarterly payment in one period can be offset by early contributions to the [funding agency](#) for another quarter.

The unfunded increased [FAR 31.205-6\(j\)\(2\)\(iii\) pension costs](#) are then accounted for as an unallowable actuarial liability in accordance with [CAS 412-50\(a\)\(2\)\(i\)](#). Specifically, the unfunded and unallowable actuarial liability is annually adjusted based on the going concern actuarial interest rate in accordance with CAS 412-50(a)(2)(ii).

If a contractor delays or partially funds a required quarterly pension contribution, the contractor should be requested to provide a copy of their procedures and controls, and provide a walk-through of the actions taken, to compute the [unallowable increased future pension costs](#). In absence of a contractor provided analysis, the following calculations will reasonably approximate the unallowable costs that should be excluded from future pension costs computations:

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Assume that pension expense of \$12 million is claimed in the cost accounting period ending December 31, 2003. However, the contractor did not make the required pension contributions until August 31, 2004. Also assume that the actuarial valuation used a six percent interest rate assumption and that the valuation date is January 1, 2004. The unallowable pension increased expense can be computed as:

Quarter	Date Payment Should be Made	Date Payment Actually Made	Number of Months in the Delay Period	Monthly Interest Rate	Delay Period Interest Factor	Prorata Quarterly Pension Expense	Increased Pension Expense
a	b	c	d=b-c	e=6%/12	f=d*e	g	h=f*g
First	4/30/03	8/31/04	16 mos.	0.5%	8.0%	\$3 million	\$242,000
Second	7/30/03	8/31/04	13 mos.	0.5%	6.5%	\$3 million	195,000
Third	10/30/03	8/31/04	10 mos.	0.5%	5.0%	\$3 million	150,000
Fourth	1/30/04	8/31/04	7 mos.	0.5%	3.5%	\$3 million	105,000
Total unallowable increased cost due to the contractor's delayed funding							<u>\$690,000</u>

The loss of earnings on the contractors' delayed quarterly contributions represents an actuarial loss and is normally accounted for as an unallowable accrued actuarial liability in accordance with CAS 412-50(a)(2). As an alternative, if mutually agreeable, the unallowable pension cost can be assigned to the current year by decrementing an equivalent amount of allowable pension costs. The ACO and the contractor may prefer this approach because it would eliminate the need to annually adjust the corresponding unallowable and unfunded actuarial liability. Such an agreement should be made in accordance with FAR 31-109.

The contractor can also elect to fund this unallowable liability in order to eliminate the required CAS 412-50(a)(2)(ii) annual adjustments. However, the funding of an unallowable liability cannot be recognized for contract costing purposes. If the contractor did recognize this cost, then the cost should be questioned.

### **53-04.3 FAR 31.205-6(j)(3) adjustments of previously accrued defined-benefit pension costs for certain extraordinary events**

For funded defined-benefit pension plans, certain extraordinary events may require an adjustment of previously determined [pension costs](#). The three extraordinary events are:

- a CAS 413-30(a)(20) [segment closing](#),
- a CAS 413-30(a)(14) [pension plan termination](#), and
- a CAS 413-30(a)(7) [curtailment of benefits](#).

The FAR 31.205-6(j)(3) adjustments are only applicable [to funded defined-benefit pension plans](#). Refer to CAM 8-413.3 for guidance on the applicable CAS 413-50(c)(12) adjustment and related FAR 31.205-6(j)(3)(i)(B) requirements.

For [all other situations](#), if the assets of a funded defined-benefit plan revert to or are constructively received by the contractor for any reason, the contractor needs to make a refund or give credit to the Government for its equitable share of the [gross amount withdrawn](#).

### **53-04.4 Forward pricing for funded defined-benefit pension plans**

#### **53-04.4.1 CAS 412-50(c)(2)(ii) Assignable Cost Limitation**

When the [actuarial value of pension plan assets](#) is greater than the corresponding [actuarial accrued liability](#), the plan is said to be overfunded. When a [funded defined-benefit pension plan](#) is overfunded or close to becoming overfunded, it can significantly impact the forward pricing negotiations for out-year pension costs.

Specifically, CAS 412-50(c)(2)(ii) limits the annual assignment of pension costs when the actuarial asset value exceeds the combined value of actuarial accrued liability and the current period's [normal costs](#). This test is known as the [Assignable Cost Limit](#) (See CAM 8-412.3). The Assignable Cost Limitation may limit pension cost over two or more cost accounting periods until the circumstances change. The pension costs will continue to be limited, potentially limited to zero, as long as the contractor's actuarial assets exceed the combined value of the actuarial liability and normal cost. The auditor should question any proposed or claimed pension costs that exceed the Assignable Cost Limitation.

Full funding and the potential for full funding can create the opportunity for a contractor to receive windfall profits when pricing fixed priced contracts. For example, the pension plan may not be fully funded at the time a fixed priced contract is negotiated, but it may become fully funded shortly thereafter. Accordingly, the contractor would receive a windfall to the extent that the contract price includes significant amounts of pension costs that, subsequently, will not be incurred for contract costing purposes during the performance period of the contract.

#### **53-04.4.2 Estimating trends for funded defined-benefit pension plans**

When plan asset values rise, future funding contribution requirements will usually fall. In many cases, contractors will have preliminary investment actuarial gain or loss calculations completed after the end of plan year but before the formal issuance of an actuary's report. In rising financial markets, the auditor needs to insure that the Government receives the full benefit of the reduced out-year costs. Consequently, contractor price proposals, indirect cost rate forecasts, and forward pricing rate agreements need to be evaluated to determine if they should include reduced forecasts due to lower pension expense related to markedly better than expected market returns on the pension assets.

After the end of a given plan year, the company's or actuary's preliminary calculations of the incurred investment actuarial gain or loss is a factual matter that prudent buyers and sellers would expect could decrease or increase the negotiated contract price.

Also, an analysis of prior year forward pricing pension estimates to the related actual pension costs may disclose a trend where estimated costs are consistently greater than the actual cost incurred. In this circumstance, the FAO should review the effect of the actuarial assumptions on the forward pricing projections to see if one or more of the actuarial assumptions is a contributing factor to the reoccurring overstatement of pension projections.

#### **53-04.5 The effect of DCMA Contractor Insurance/Pension Reviews (CIPRs) on subsequent audits**

The results of CIPRs are an important factor in determining the extent to which insurance and pensions are given audit coverage under incurred cost and forward pricing audits.

The auditor should appropriately follow-up on prior CIPR findings and recommendations. When the CIPR discloses that the contractor's pension programs are reasonable and effectively maintained, and assuming no significant change in conditions since the previous CIPR, the audit scope should be adjusted to reflect the CIPR efforts and findings. Conversely, when significant deficiencies were disclosed by a previous CIPR, the auditor should verify that corrective action was taken. If corrective action has not been accomplished, the auditor should ascertain the reason(s) for

inaction. The ACO should be advised of any significant continuing deficiencies, obtain the status of corrective action plans, and the audit scope appropriately adjusted.

#### **53-04.6 GAAP and ERISA accounting requirements**

Overall, the methods for calculating defined-benefit pension costs under GAAP are different from those required under CAS 412 and 413. Accordingly, when a contractor's financial accounting methods are in accordance with GAAP, these financial accounting practices will generally not be acceptable for cost accounting purposes. Recognizing the differences between GAAP and CAS pension accounting is important because the audit team needs to understand the different purposes and be able to ascertain the basis used to compute the various actuarial schedules and tables provided within the actuary's annual valuation reports.

For GAAP purposes, companies are required to:

- use the concept of conservative accounting for the components of pension cost,
- use realistic statistics on companies' pension plan current obligations, and
- report the company's financial pension obligations on the balance sheet.

GAAP requires the use of the unit credit actuarial cost method (used for fixed-benefit plans) or the projected unit credit actuarial cost method (used for percent of final pay plans). In addition to the unit credit and the projected unit credit actuarial cost methods, the requirements of CAS 412.50(b)(1) will permit a contractor to use the entry age normal actuarial cost method. This additional actuarial cost method may be used because it (i) separately identifies normal costs, and (ii) computes the necessary components of the unfunded actuarial liability, including the annual determination of actuarial gains and losses.

Although the CAS accounting requirements for funded defined-benefit pension plans were harmonized with the ERISA minimum funding requirements and the two requirements are now conceptually aligned, there are significant computational differences between CAS and ERISA for the measurement, assignment, and funding of pension costs. Accordingly, separate funded defined-benefit pension plan actuarial reports and/or schedules are still needed to measure and assign the differing values of pension costs under CAS and ERISA.

### **Frequently Asked Question**

**Question:** I am working on a review of compensation. How are pension costs considered in that evaluation if I have either a defined-benefit or defined-contribution pension plan?

**Answer:** A contractor's fringe benefit package is normally considered reasonable when the allowable benefit rate, calculated as a percentage of payroll, does not exceed the average rate of the comparison data by more than 10 percent. Accordingly, only when the fringe benefit package rate is markedly greater than the comparison data would we evaluate the individual elements in a benefit package. In those cases, we need to consider that many companies have (i) closed their defined-benefit pension plans to new employees, or (ii) curtailed those plans so the existing participants are no longer earning additional benefits, or (iii) both closed and then curtailed their defined-benefit pension plans. Accordingly, your contractor may have:

- Employees that are grandfathered into one or more defined-benefit plans, but are prospectively earning pension benefits through one or more defined-contribution plans, and
- A separate population of more recently hired employees that exclusively participate in one or more defined-contribution pension plans.

If your compensation audit requires a cost element by cost element evaluation of the fringe benefit portion of total compensation, you will need to understand how the employees are collectively earning their pension benefits for the given audit period, and then consider how those circumstances will impact the employees or job classes that have been selected for substantive audit testing.

Regardless of how the retirement benefits are provided, pension benefits are only one element of the total compensation package. Under FAR 31.205-6(b)(2), compensation for an employee or a class of employees is reasonable if each measurable and allowable element sums to a reasonable total. In determining benchmarks for what is reasonable total compensation for a given employee or job class, the contractor should consider the relevant organizational factors, such as the size of the company, its industry classification, the geographical area, and whether the selected peer group is engaged in similar types of non-government work. Accordingly, the audit team's consideration of the reasonableness of the pension cost element is part of an overall examination of total employee compensation for a given employee or job class. The reasonableness of pension benefits is not audited on a stand-alone basis but is a contributing factor to the overall reasonableness of (i) fringe benefits under FAR 31.205-6(m), and (ii) total compensation under FAR 31.205-6(b)(2).

As such, a detailed examination of the pension benefits on an employee or class of employee basis is only performed where there is a demonstrated risk. For example, where the value of the pension benefits offered by a contractor is significantly more (or less) generous than the average pension benefit provided by the company's peer group,

then the contractor's compensation practices are allowed to offset those amounts against any lower (or higher) than average salary, bonuses, vacations, and/or medical benefits. Accordingly, in most cases it is not necessary to perform additional testing of the pension benefits or other fringe benefit components when the initial risk assessment or preliminary audit procedures determine (i) the overall fringe benefits earned by the selected employees or job class are reasonable, in comparison to the company's appropriately selected peer group, or (ii) the contractor's total cash (salary and bonus) compensation is significantly under the market benchmarks.

However, when the risk assessment or initial audit steps indicate that the pension benefits will impact the audit evaluation of total employee compensation and, therefore, needs to be separately benchmarked in order to determine a reasonable amount of overall employee compensation, then the value of the defined-benefit and defined-contribution benefits must be separately computed by plan type as follows:

- The value of the historical annual average compensation for a participating employee is normally readily available for a defined-contribution pension plan. Specifically, the allowable pension costs are measured as the net contribution required for the period and are normally funded to individual employee accounts.
- Determining the value for the historical annual average compensation attributable to defined-benefit pension plans normally requires (i) the use of net present value computations and assumptions about future employee service, life expectancy, and the other factors on which the future retirement payments are determined, and (ii) an allocation of the average compensation provided by the plan to the employees or job classifications selected for testing.

However, quantifying the value of pension benefits is in many cases unnecessary for the reasons described above or because the pension benefits can themselves be determined reasonable through other analytical and/or comparative procedures (e.g., see section 53.02.3).

Where necessary, the audit team should consult with the regional pension or compensation specialists for assistance with the computation of the value for the contractor's historical annual average pension benefit. However, if the benefits are based on an arm's length labor-management agreement, the elements of employee compensation covered by the agreement will normally be considered reasonable under FAR 31.205-6(b)(1).

## Callout

**CAS and FAR** - Effective June 2, 2008, ESOP costs are subject to CAS 415. The ESOP allowability criteria were moved to FAR 31.205-6(q) as of January 12, 2004. ([Return](#))

**Contributory** - A plan is called contributory if the participants are allowed (or required) to make contributions to it, usually in the form of payroll deductions. ([Return](#))

**Noncontributory** - A non-contributory plan does not permit contributions by plan participants. ([Return](#))

**Established Plan** - Pension payments must be paid pursuant to an agreement entered into in good faith between the contractor and employees before the work or services are performed and to the terms and conditions of the established plan. FAR 31.205-6(j)(1)(ii) ([Return](#))

**Cost of Changes** - the costs of changes in pension plans are not allowable if the changes are discriminatory to the Government or are not intended to be applied consistently for all employees under similar circumstances in the future. FAR 31.205-6(j)(1)(ii). ([Return](#))

**Allowable** - Increases in payments to previously retired plan participants covering cost-of-living adjustments are allowable if paid in accordance with a policy or practice consistently followed. FAR 31.205-6(j)(1)(iv). ([Return](#))

**Early Retirement Incentive Plans** - The incentives are in accordance with the terms and conditions of an early retirement incentive plan. FAR 31.205-6(j)(6)(ii). ([Return](#))

**Active Employees** - The contractor applies the plan only to active employees. The cost of extending the plan to employees who retired or were terminated before the adoption of the plan is unallowable." FAR 31.205-6(j)(6)(iii). ([Return](#))

**Separate Segment** - The computation of a separate pension cost for a segment is required when certain conditions exist for a segment that would materially affect the amount of pension cost allocated to the segment. See CAM 8-413.2b. ([Return](#))

**Pay as You Go** - The CAS 412-40(a)(3) pay-as-you-go method can only be used for unqualified defined-benefit pension plans in accordance with CAS 412-50(c)(4). ([Return](#)).

**Funded Defined-Benefit Pension Plan** - As used in this chapter, the phrase "funded defined-benefit pension plan" is any defined-benefit pension plan that is not accounted for on the CAS 412-30(a)(19) and 412-40(a)(3) pay-as-you go basis. ([Return 1](#)) ([Return 2](#))

**All Other Situations**- FAR 31.205-6(j)(3)(ii) "all other situations" requirement was added in 1998 to protect against the possibility that future legislation might allow funded pension assets to be used for other purposes. This type of legislation has not been passed. ([Return](#))

**Assignable Cost Limitation** - the excess, if any, of the actuarial accrued liability and the normal cost for the current period over the actuarial value of the assets of the pension plan." CAS 412-30(a)(9). ([Return](#))

**Actuarial Value** – “The actuarial value of the assets of a pension plan shall be determined under an asset valuation method which takes into account unrealized appreciation and depreciation of the market value of the assets of the pension plan...” CAS 413-40(b). ([Return](#))

## Definitions

**Pension Plan** – 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. FAR 31.001 and CAS 412-30(a)(20) ([Return](#))

**Employee Stock Ownership Plans (ESOPs)** - (i) An employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock, and (ii) Any other deferred compensation plan designed to invest primarily in the stock of the contractor's corporation including, but not limited to, plans covered by ERISA. ([Return](#))

**FAR 31.2 Covered Contracts** - This includes all contracts and contract modifications for supplies, services, or experimental, developmental, or research work negotiated with organizations other than educational institutions (see FAR 31.104), construction and architect-engineer contracts (see FAR 31.105), State and local governments (see FAR 31.107) and nonprofit organizations (see FAR 31.108) on the basis of cost. FAR 31.103. Accordingly, this includes (i) all full and modified CAS covered contracts, and (ii) all CAS exempt contracts and modifications negotiated on the basis of cost. ([Return](#))

**Defined-Contribution Plan** - A pension plan in which the contributions are established in advance and the benefits are determined thereby. CAS 412-30(a)(11) and FAR 31.001. ([Return](#))

**Defined-Benefit Plan** - A pension plan in which the benefits to be paid or the basis for determining such benefits are established in advance and the contributions are intended to provide the stated benefits. CAS 412-30(a)(10) and FAR 31.001. ([Return](#))

**Insured** – A plan is called an insured type if its funding agency is an insurance company. Here, the plan sponsor makes contributions to an insurance company, and the insurance company issues various types of contracts to provide the designated plan benefits. Some insurance arrangements provide investment services only, without guarantees of benefits, investments or earnings. ([Return](#))

**Trusteed** - A plan is called a trustee type if its funding agency is a trust fund. Contributions go to the trustees who in turn invest and manage the assets and pay the stated benefits. The trustees can be third parties, such as banks, or individuals, including employees of the contractor. ([Return](#))

**Qualified Pension Plan** - A pension plan comprising a definite written program communicated to and for the exclusive benefit of employees which meets the criteria deemed essential by the Internal Revenue Service as set forth in the Internal Revenue Code for preferential tax treatment regarding contributions, investments, and distributions. Any other plan is a Nonqualified Pension Plan. CAS 412-30(a)(25). ([Return](#))

**Business Unit** - Any segment of an organization, or an entire business organization which is not divided into segments. 48 CFR 9903.301. A 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. CAS 413-30(a)(19). ([Return](#))

**Pension Plan Participant** - 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 pension 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 participant of the employer's pension plan." CAS 412-30(a)(21). ([Return](#))

**Unallowable** - "...one-time-only pension supplements not available to all participants of the basic plan are not allowable as pension costs, unless the supplemental benefits represent a separate pension plan and the benefits are payable for life at the option of the employee." FAR 31.205-6(j)(1)(iii). ([Return](#))

**Case by Case Basis** - "The contracting officer will consider the allowability of the cost of indemnifying the Pension Benefit Guaranty Corporation (PBGC) under ERISA Section 4062 or 4064 arising from terminating an employee deferred compensation plan on a case-by-case basis; provided that if insurance was required by the PBGC under ERISA section 4023, it was so obtained and the indemnification payment is not recoverable under the insurance. Consideration under the foregoing circumstances will be primarily for the purpose of appraising the extent to which the indemnification payment is allocable to Government work. If a beneficial or other equitable relationship exists, the Government will participate, despite the requirements of 31.205-19(c)(3) and (d)(3), in the indemnification payment to the extent of its fair share." FAR 31.205-

6(j)(2)(iv) for defined benefit plans and FAR 31.205-6(j)(4)(ii) for defined-contribution plans. ([Return](#))

**Costs in Future Periods** - “Any amount funded in excess of the pension cost assigned to a cost accounting period is not allowable and shall be accounted for as set forth at 48 CFR 9904.412-50(a)(4). The excess amount is allowable in the future period to which it is assigned, to the extent it is not otherwise unallowable.” FAR 31.205-6(j)(2)(ii) for defined benefit plans and FAR 31.205-6(j)(4)(ii) for defined-contribution plans. This requirement is the same as CAS 412-50(a)(4). ([Return](#))

**Annual Salary** - The present value of the total incentives given to any employee in excess of the amount of the employee’s annual salary for the previous fiscal year before the employee’s retirement is unallowable. The contractor shall compute the present value in accordance with its accounting practices for pension costs. The contractor shall account for any unallowable costs in accordance with 48 CFR 9904.412-50(a)(2). FAR 31.205-6(j)(6)(iv). ([Return](#))

**Increased Pension Cost** - Unallowable if the increase is caused by a delay in funding beyond 30 days after each quarter of the year to which they are assignable...The contractor shall make determinations of unallowable costs in accordance with the actuarial method used in calculating pension costs. FAR 31.205-6(j)(2)(iii). ([Return](#))

**Transfer** - In September 1991, FAR 31.205-6(j)(2) was revised to require an advance agreement for a transfer of pension fund assets to another post-retirement benefit fund or account. The advance agreement is to ensure that the increased pension costs to the Government, in all future periods are offset by a corresponding reduction of future post-retirement benefit costs to the Government. If a transfer is made without an advance agreement, it is treated as a withdrawal of pension funds subject to FAR 31.205-6(j)(3) Pension adjustments and asset reversions. ([Return](#))

**Advanced Agreement** - Increased pension costs resulting from the withdrawal of assets from a pension fund and transfer to another employee benefit plan fund, or transfer of assets to another account within the same fund, are unallowable except to the extent authorized by an advance agreement. If the withdrawal of assets from a pension fund is a plan termination under ERISA, the provisions of paragraph (j)(3)(ii) of this subsection apply. The advance agreement shall—

(A) State the amount of the Government’s equitable share in the gross amount withdrawn or transferred; and

(B) Provide that the Government receives a credit equal to the amount of the Government’s equitable share of the gross withdrawal or transfer. FAR 31.205-6(j)(2)(v) ([Return](#))

**Funding Agency** - an organization or individual which provides facilities to receive and accumulate assets to be used either for the payment of benefits under a pension plan,

or for the purchase of such benefits, provided such accumulated assets form a part of a pension plan established for the exclusive benefit of the plan participants and their beneficiaries. The fair market value of the assets held by the funding agency as of a specified date is the Funding Agency Balance as of that date. CAS 412-30(a)(13). ([Return](#))

**Quarter** - Increased pension costs are unallowable if the increase is caused by a delay in funding beyond 30 days after each quarter of the year to which they are assignable...The contractor shall make determinations of unallowable costs in accordance with the actuarial method used in calculating pension costs. FAR 31.205-6(j)(2)(iii). ([Return](#))

**FAR 31.206-6(j)(2)(iii)** - Increased pension costs are unallowable if the increase is caused by a delay in funding beyond 30 days after each quarter of the year to which they are assignable. If a composite rate is used for allocating pension costs between the segments of a company and if, because of differences in the timing of the funding by the segments, an inequity exists, allowable pension costs for each segment will be limited to that particular segment's calculation of pension costs as provided for in 48 CFR 9904.413-50(c). The contractor shall make determinations of unallowable costs in accordance with the actuarial method used in calculating pension costs. ([Return](#))

**CAS 412-50(a)(2)(i)** - Except as provided in 9904.412-50(d)(2), any portion of unfunded actuarial liability attributable to either pension costs applicable to prior years that were specifically unallowable in accordance with then existing Government contractual provisions or pension costs assigned to a cost accounting period that were not funded in that period, shall be separately identified and eliminated from any unfunded actuarial liability being amortized pursuant to paragraph (a)(1) of this subsection. ([Return](#))

**Future Pension Costs** - Increased pension costs are unallowable if the increase is caused by a delay in funding beyond 30 days after each quarter of the year to which they are assignable. If a composite rate is used for allocating pension costs between the segments of a company and if, because of differences in the timing of the funding by the segments, an inequity exists, allowable pension costs for each segment will be limited to that particular segment's calculation of pension costs as provided for in 48 CFR 9904.413-50(c). The contractor shall make determinations of unallowable costs in accordance with the actuarial method used in calculating pension costs. FAR 31.205-6(j)(2)(iii). ([Return](#))

**Pension Costs** - ...the amount adjustment shall be—

(A) For contracts and subcontracts that are subject to full coverage under the Cost Accounting Standards (CAS) Board rules and regulations, the amount measured, assigned, and allocated in accordance with 48 CFR 9904.413-50(c)(12); and

(B) For contracts and subcontracts that are not subject to full coverage under the CAS, the amount measured, assigned, and allocated in accordance with 48 CFR 9904.413-

50(c)(12), except the numerator of the fraction at 48 CFR 9904.413-50(c)(12)(vi) is the sum of the pension plan costs allocated to all non-CAS-covered contracts and subcontracts that are subject to Subpart 31.2 or for which certified cost or pricing data were submitted. FAR 31.205-6(j)(3)(i). ([Return](#))

**Segment Closing** - a segment has (i) been sold or ownership has been otherwise transferred, (ii) discontinued operations, or (iii) discontinued doing or actively seeking Government business under contracts subject to this Standard.” CAS 413-30(a)(20). ([Return](#))

**Pension Plan Termination** - an event; i.e., plan amendment, in which either the pension plan ceases to exist and all benefits are settled by purchase of annuities or other means, or the trusteeship of the plan is assumed by the Pension Benefit Guarantee Corporation or other conservator. The plan may or may not be replaced by another plan. CAS 413-30(a)(14). ([Return](#))

**Curtailment of Benefits** - an event; e.g., a plan amendment, in which the pension plan is frozen and no further material benefits accrue. Future service may be the basis for vesting of nonvested benefits existing at the time of the curtailment. The plan may hold assets, pay benefits already accrued, and receive additional contributions for unfunded benefits. Employees may or may not continue working for the contractor.” CAS 413.30(a)(7). ([Return](#))

**Gross Amount Withdrawn** - For all other situations where assets revert to the contractor, or such assets are constructively received by it for any reason, the contractor shall, at the Government’s option, make a refund or give a credit to the Government for its equitable share of the gross amount withdrawn. The Government’s equitable share shall reflect the Government’s participation in pension costs through those contracts for which certified cost or pricing data were submitted or that are subject to Subpart 31.2. Excise taxes on pension plan asset reversions or withdrawals under this paragraph (j)(3)(ii) are unallowable in accordance with 31.205-41(b)(6). FAR 31.205-6(j)(3)(ii). ([Return](#))

**Actuarial Accrued Liability** - pension cost attributable, under the actuarial cost method in use, to years prior to the current period considered by a particular actuarial valuation. As of such date, the actuarial accrued liability represents the excess of the present value of future benefits and administrative expenses over the present value of future normal costs for all plan participants and beneficiaries. The excess of the actuarial accrued liability over the actuarial value of the assets of a pension plan is the Unfunded Actuarial Liability. The excess of the actuarial value of the assets of a pension plan over the actuarial accrued liability is an actuarial surplus and is treated as a negative unfunded actuarial liability.” CAS 412-30(a)(2). ([Return](#))

**Normal Cost** - the annual cost attributable, under the actuarial cost method in use, to current and future years as of a particular valuation date, excluding any payment in respect of an unfunded actuarial liability.” CAS 412-30(a)(18). ([Return](#))

**Assignable Cost Limit** - the excess, if any, of the actuarial accrued liability and the normal cost for the current period over the actuarial value of the assets of the pension plan." CAS 412-30(a)(9). ([Return](#))