ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeal of --	)	
	)	
Eastman Kodak Company	)	ASBCA No. 51326
	)	
Under Contract No. F33657-79-C-0127	)	

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OPINION BY ADMINISTRATIVE JUDGE PEACOCK

This timely appeal concerns a contracting officer's final decision claiming entitlement to a refund of $9,617,856 under the referenced contract and other flexibly-priced contracts between Eastman Kodak Company (Kodak or appellant) and the Government on the ground that appellant's method of accounting for pension costs for the period 1984 through 1986 was noncompliant with the Cost Accounting Standards (CAS). The pertinent CAS provisions are set forth in an Appendix to this decision. Only entitlement is before us for decision. We deny the appeal.

FINDINGS OF FACT

A. The Contract

1. The captioned contract is a cost-plus-fixed-fee contract awarded to Kodak on 29 November 1978, to perform classified work for the Government. The parties have stipulated that "the outcome of this appeal will control the Contract and all other flexibly-priced Government contracts and subcontracts performed by Kodak between 1984 and 1986 that are subject to" the CAS. (JS-3)[1]

2. The contract included the following Armed Services Procurement Regulation ("ASPR") clauses: (1) ASPR 7-104.83(a) COST ACCOUNTING STANDARDS (1975 FEB) (Modified); (2) ASPR 7-104.83(b) ADMINISTRATION OF COST ACCOUNTING STANDARDS (1975 MAR); (3) ASPR 7-403.9 NEGOTIATED OVERHEAD RATES (1970 SEP) and (4) ASPR 7-203.4(a) ALLOWABLE COST, FIXED FEE, AND PAYMENT (1974 APR) (JS-5).

3. Allowability of costs under the contract is governed by the following cost principles among others: (1) ASPR 15-205.6(f), COMPENSATION FOR PERSONAL SERVICES, DEFERRED COMPENSATION and (2) ASPR 15-201.5, CREDIT (JS-6).

4. The measurement, assignment, and allocation of Kodak's pension costs under the contract are governed by CAS 412, Cost Accounting Standard for Composition and Measurement of Pension Cost and CAS 413, Adjustment and Allocation of Pension Cost, 4 C.F.R. Ch. III §§ 412, 413 (1986) (JS-7).

B. <u>The Kodak Retirement Income Plan</u>

1. <u>General</u>

5. The Kodak Retirement Income Plan (hereinafter "KRIP" or "the pension plan") is a defined-benefit pension plan maintained by Kodak for all of its employees. The KRIP is a "qualified pension plan" within the meaning of section 401 of the Internal Revenue Code, 26 U.S.C. § 401, Qualified pension, profit-sharing, and stock bonus plans. (JS-8)

6. The annual pension expense recorded in Kodak's financial records was calculated by its actuaries and allocated by the corporate office on a payroll basis to Kodak's various divisions, including the Kodak Apparatus Division ("KAD"), which performed the contract. KAD allocated its share of the total pension expense on an indirect basis to all of its Government contracts and subcontracts. (JS-9)

2. <u>Kodak's Actuarial Cost Methods</u>

a. <u>Before 1982</u>

7. Before 1982, Kodak used the Frozen Initial Liability actuarial cost method ("FIL method") to calculate its annual pension expense for all purposes, including: (a) funding, *i.e.*, the amount contributed to a pension plan in accordance with the Employee Retirement Income Security Act of 1974 ("ERISA"), Pub. L. No. 93-406; (b) financial reporting, *i.e.*, the amount of pension expense assigned to an accounting period and included on the balance sheet and income statement for that period in accordance with Opinion No. 8 of the Accounting Principles Board (APB 8); and (c) Government contract cost accounting, *i.e.*, the amount of pension cost allocated to Kodak's Government contracts. (JS-10)

8. The actuarial cost method disclosed to the Government in Kodak's CAS Disclosure Statement, dated 27 January 1982, was "Entry age - initial liability frozen," *i.e.*, the Entry Age Normal ("EAN")/FIL method (JS-11).

9. The FIL method is a "spread-gain" actuarial cost method, sometimes also referred to as an "aggregate cost method." This method does not independently produce a value for Kodak's unfunded actuarial liability, which is a necessary component for determining the funding status of a pension plan. The method does not identify separately the discrete components of pension costs, *i.e.*, normal costs, unfunded actuarial liabilities and actuarial gains and losses within the meaning of CAS 412.50(b)(1). Rather, such a cost method spreads the entire cost of future pension benefits over the average future service lives of the current work force and does not develop actuarial gains or losses. Therefore, under CAS 412.50(b)(2)(ii) and ERISA, Kodak was required to use a different method to calculate the funded status of KRIP. Kodak made the calculation required by CAS and ERISA using the EAN method. (JS-12; APF 81)

b. Adoption of a New Actuarial Cost Method

10. Effective 1 January 1982, Kodak adopted the Projected Unit Credit (PUC) actuarial cost method to calculate its annual pension expense for financial reporting purposes (JS-14). The PUC method is an "immediate-gain" actuarial cost method, which identifies separately normal costs, unfunded actuarial liabilities, and actuarial gains and losses within the meaning of CAS 412.50(b)(1) (JS-16). An immediate gain actuarial method does disclose the funding status of a pension plan, unlike the spread gain actuarial method (tr. 33-34). Kodak changed to the PUC method because management had concluded that continued use of the FIL method would cause the company to contribute more to the pension plan than would be necessary (JS-17, -18). A spread gain method (such as FIL) generally produces a higher current period cost (tr. 40, 246). As of 1 January 1982, Kodak's unfunded actuarial liability under the PUC method was $55,792,000, compared with an unfunded actuarial liability of $791,440,000 under the FIL method (JS-13, -23).

11. Financial accounting requirements, as set forth in APB 8 during the period in dispute, were not concerned with funding or the amount paid to a pension plan. Pursuant to APB 8 requirements for accrual accounting, amounts funded were not determinative of pension costs for financial reporting purposes. (Tr. 30; GPF 114) APB 8 does not create a liability to fund pension costs computed for financial reporting (tr. 228). Appellant considers APB 8 to be irrelevant to this appeal and does not assert that financial reporting (or generally accepted accounting principles) requirements imposed any obligation or liability to fund its pension plan or otherwise support its entitlement to recover in this appeal. (App. reply brief at 11, 33)

12. For tax reasons, Kodak continued to use the FIL method for funding purposes in 1982 (JS-14, -19). With the approval of the Internal Revenue Service, Kodak adopted the PUC method for funding purposes effective January 1, 1983 (JS-17, -21).

13. For Government contract purposes, Kodak allocated the same amount of pension expense that was calculated for financial reporting purposes under the PUC method to its divisions, including KAD beginning in 1982. Pursuant to the PUC method, Kodak allocated much less pension cost to its Government contracts than the amount that would have been allocated had Kodak continued to use the FIL method. (JS-15)

14. Kodak's change from the FIL method to the PUC method was a change in cost accounting practice. During the period at issue, Kodak had no process by which changes in cost accounting practice were communicated to the various Kodak divisions and subdivisions. At the time of the change, the corporate officials who were responsible for pension policies did not consult with the various divisions and were not aware that Kodak was required to amend its CAS Disclosure Statement. Kodak did not inform the contracting officer about the change, and did not amend its CAS Disclosure Statement to reflect the change until 22 June 1990. (JS-22)

15. Kodak also changed certain actuarial assumptions for KRIP beginning in 1982, which the parties have stipulated were not "change[s] to a cost accounting practice" within the meaning of 4 C.F.R. § 331.20(1), Definitions (AR4, tab 23). (JS-20)

C. <u>Kodak's Pension, Expenses and CAS Costs</u>

1. <u>Pension Expenses</u>

16. Kodak made payments totaling $360,750,000 with respect to its pension plan in 1982 (JS-24).

17. Kodak's actuarial firm, Towers Perrin, calculated the company's 1984 through 1986 annual pension expense for financial reporting, tax, and ERISA purposes. The actuarial reports for the period at issue did not contain separate pension calculations under CAS 412 or CAS 413. The actuaries who prepared the reports did not consider CAS, and did not know how Kodak was treating its pension costs for Government contract cost purposes. (JS-26)

18. Using the PUC method, Kodak's calculated pension expense for 1982 was $118,350,000. Thus, for financial reporting purposes, Kodak's contribution in 1982 of $360,750,000 resulted in the prepayment of future pension plan expenses in the approximate amount of $242,400,000. (JS-27) The prepayment was not charged to Government contracts in 1982 (JS-29).

19. Independent of a pension fund's funding status a contractor may deposit money into the pension fund and earn the return. These extra amounts funded are referred to as prepayment credits because they are available in future periods to represent the funding of allocable pension cost. (Ex. G-2 at 8; GPF 39) For purposes of calculating the funded status of a pension plan, prepayment credits and related interest equivalents are excluded from the calculations. Such credits neither reduce an underfunded amount, unless the contractor makes that decision, nor increase the amount of any excess. (Ex. G-2 at 9; GSR4, tab 1 at 7 n.25; GPF 40). Prepayments are excluded from the asset number when computing pension costs under CAS 412 (tr. 147, 225; GPF 41). Prepayments are separately accounted for in the pension fund because when the actuary calculates what the actuarial liability is and compares it with the assets, the actuary separates any prefunding out; it is not included in trying to assess whether the plan is overfunded (tr. 146; GPF 43). Prepayments are carried forward (with interest) to be applied against the costs of future periods (ex. G-2 at 19-21).

20. For financial reporting purposes, Kodak's corporate office created an account for prepaid pension expense in the amount of $242,400,000, which was the amount of the 1982 contribution in excess of the 1982 pension expense of $118,350,000. After receiving notice of the amount of the annual pension expense for financial purposes from its actuary in later years, Kodak's corporate office could credit the prepaid pension expense and debit the pension expense for that amount. (JS-28)

21. In 1982, Kodak's corporate office allocated $118,350,000 in pension expense to Kodak's divisions on a payroll basis. A portion of the expense that was allocated to KAD was further allocated to the segments performing Government contracts and subcontracts. (JS-29)

22. Use of the FIL method for funding purposes in 1982 allowed Kodak to deduct from its income for federal income tax purposes the entire $360,750,000: a $240,750,000 deduction from its income for 1982 and a $120,000,000 "carry back" deduction for 1981 (JS-24).

23. At the time of prepayment in 1982, the pension plan was not overfunded, *i.e.*, the actuarial value of the plan's liabilities exceeded the actuarial value of the plan's assets. The 1982 prepayment did not cause the plan to be overfunded. (JS-30)

24. The excess of assets over liability in a pension plan is variously referred to as overfunding, excess funding or surplus (GPF 32; app. reply brief at 10). "Fully funded" generally describes a situation where the assets of a pension plan exceed its liabilities, thereby limiting or eliminating tax deductable contributions to the plan (ex. A-P at 14). The KRIP first became overfunded for Government contract purposes on January 1, 1984. The pension plan became overfunded for a variety of reasons, including gains in the stock market, the change in the plan's assumptions noted above, the prepayment in 1982,

favorable investment experience, and the change in the actuarial method (FIL to PUC) used by Kodak. (JS-30)

25. Kodak elected to apply the prepayment that had been made in 1982 (plus interest earned) to fund the entire amount of the 1984 and 1985 pension expense, $84,093,850, and $76,414,560, respectively, and $29,015,000 of the annual pension expense Kodak calculated in 1986 ($68,675,000) (JS-31; R4, tabs 12, 58). The Government's share of this expense, as determined by Kodak, was included in the final indirect cost rates for 1984 through 1986, on which the payments the Government made to Kodak were based. (JS-31) Application of available prepayment credits to defray pension costs was optional for appellant (tr. 292-93).

26. For the period in dispute Kodak's maximum deductible contribution and minimum required contribution for tax and ERISA purposes were zero (JS-24). Kodak had no legal obligation to make contributions to the pension plan during that period (JS-25).

27. In 1990, Kodak and the Government agreed on final indirect cost rates for 1982 and 1983 (JS-29).

2. Kodak Pension Costs Under CAS

28. In December 1995, Towers Perrin calculated Kodak's pension costs for the period at issue under CAS 412.40(a)(1) using the FIL and PUC methods. Kodak's actuarial consultant, John B. McQuade, subsequently revised these calculations as follows (JS-32):

Kodak Pension Costs Under CAS 412
(thousands of dollars)

	1984 CAS 412 Cost	1985 CAS 412 Cost	1986 CAS 412 Cost
Normal cost	101,372	107,811	117,413
Amortization payments	(11,559)	(30,676)	(52,854)
Interest on normal cost and amortization	5,726	4,917	4,116
Total measured cost	95,539	82,052	68,675
Pension costs assigned to Kodak divisions	84,094	76,415	29,015

29. The McQuade calculations were used as the basis for Kodak's final indirect cost submissions for 1984 through 1986 and Kodak was paid on the basis of those submissions. Thus, the amount the Government seeks to recover from Kodak is based on these calculations (JS-33) There are no material differences between Mr. McQuade's results and those developed by Towers Perrin (GPF 61). The parties agree that, to the extent (if

any) Kodak's pension costs are properly assigned to accounting periods and allocated to contracts from 1984 to 1986, the above amounts are accurate (JS-33).

30. In performing his analysis, Mr. McQuade followed a "sequential" approach to determining Kodak's allowable pensions costs in 1984 through 1986, using a series of steps: first, "pension cost is measured"; second, the "measured pension cost is assigned to cost accounting periods"; third, the "assigned pension cost is allocated to cost objectives of that cost accounting period"; and fourth, "[s]ome or all of the pension costs that is allocated to Government contracts is allowed on those contracts" (ex. A-P at 18).

31. In the "first step [of] the process," appellant measured Kodak's pension cost, taking into consideration the following "four components of pension costs" identified in CAS 412.40(a)(1):

> (1) The normal cost (CAS 412.40(a)(i));
>
> (2) A provision to amortize a portion of the principal of any unamortized unfunded actuarial liability (CAS 412.40(a)(1)(ii));
>
> (3) Interest on the unamortized unfunded actuarial liability (CAS 412.40(a)(1)(iii)); and
>
> (4) An adjustment for actuarial gains and losses (CAS 412.40(a)(1)(iv)).

(Ex. A-P at 18-19)

32. In calculating the annual measured cost, Mr. McQuade considered that the first three components of cost are reduced by an amortization of any actuarial gains that have occurred in the pension plan (tr. 232-33). According to Mr. McQuade, under Kodak's interpretation of CAS, the Government receives the benefit of the actuarial gain that causes any pension plan surplus to arise over the 15-year amortization period required by CAS 413.50. (Tr. 303-04) Thus, the Government is "given credit" in the form of a reduction in the otherwise measured cost to account for the actuarial gains occurring in the pension plan that have arisen as a result of past reimbursements (tr. 306-07).

33. In his third step, Mr. McQuade considered whether the assigned pension costs can be allocated to Government contracts. Mr. McQuade applied CAS 412.40(c), which states that pension costs are allocable "to the extent that liquidation of the liability for such cost can be compelled or liquidation is actually effected in that period." Mr. McQuade and Kodak concede that liquidation of the 1984, 1985, and 1986 pension costs could not be compelled within the meaning of CAS 412.40(c). Mr. McQuade determined, however, that

liquidation of Kodak's 1984 and 1985 pension costs was "actually effected" by the "unique" (tr. 283-84) 1982 prefunding, and that liquidation of $29,015,000 of Kodak's 1986 total assigned pension cost of $68,675,000 was "actually effected" by the 1982 prefunding. Accordingly, Mr. McQuade concluded that the entire $84,094,000 in pension cost assigned to 1984 was allocable to Kodak's Government contracts in 1984, the entire $76,415,000 in pension cost assigned to 1985 was allocable to Kodak's Government contracts in 1985, and $29,015,000 of the $68,675,000 in pension cost assigned to 1986 was allocable to Kodak's Government contracts in 1986. (Ex. A-P at 29-30) The remaining pension costs of approximately $39 million were not allocable because the prefunding had been exhausted (tr. 294; GPF 84).

34. Appellant concedes that in the absence of the $242,400,000 prefunding in 1982, no pension costs would be allocable to cost objectives during the period in dispute (GPF 85; app. reply brief at 24). Appellant's pension fund remained overfunded from 1987 through 1995. (APF 34, 43)

35. The Government's position with respect to the detailed measurement of pension cost was developed by its actuarial expert, Mr. Eric Shipley. To the extent pertinent, the rationale for Mr. Shipley's calculations is set forth in the Expert Testimony section of this opinion, *infra*. Mr. Shipley's computations for 1983 indicate that, after reducing the actuarial value of assets, by the value of the prepayment credits, the plan was underfunded and there was a "liability" under ERISA to pay the cost he computed for that year (ex. G-1 at 8-10). Although he determined that a cost was allocable in 1983, he used the same method of accounting for the prepayment as he did in 1984-1986 (ex. G-1 at 8-15).

D. <u>Expert Opinions</u>

36. Mr. John B. McQuade, appellant's expert, is president of Fidelity Investments Actuarial and Consulting Services, Inc. He has approximately 25 years of experience in the actuarial field. His areas of expertise include advising Government contractors on all aspects of administration of their defined benefit pension plans under Federal Government procurement rules generally, and, in particular, providing advice with regard to pertinent requirements of the CAS and FAR. Mr. McQuade graduated from Bates College in 1975 with a B.A. in Mathematics. In 1975 he became an associate of the Society of Actuaries and in 1979, he became a fellow of the Society of Actuaries, a member of the American Academy of Actuaries, and an Enrolled Actuary.

37. In Mr. McQuade's opinion Kodak's pension costs were properly measured and assigned to the years 1984 through 1986 and were properly allocable to cost objectives during that period. With regard to allocability, Mr. McQuade interprets the operative provision CAS 412.40(c) as authorizing allocation of assigned pension costs because "liquidation of [the pension costs] was actually effected" in each of the periods in dispute. He concedes that there was no "liability" that Kodak could be compelled to liquidate.

Under his interpretation of CAS 412.40(c), however, there is no requirement for a "liability" if the measured and assigned pension costs are "liquidated," *i.e*., actually funded in the periods from the prepayment credit account. Mr. McQuade considers that the allocability test is satisfied if liquidation can be compelled or funding actually occurs. Because Kodak funded the costs, Mr. McQuade concludes that the costs are properly allocable. According to Mr. McQuade, the CASB's concern, as expressed in paragraph 11 of the Preamble to CAS 412, was that the Government should not be required to reimburse pension costs that might never be funded. Here, Mr. McQuade stresses that Kodak funded the pension costs alleviating this concern. (Ex. A-P at 29-30, 46-48)

38. The Government's actuarial expert, Eric Shipley, has held the position of Actuary in the Health Care Financing Administration's Office of the Actuary since October, 1986. He is a fellow in the Conference of Consulting Actuaries, an enrolled actuary, and a member of the American Academy of Actuaries. (Ex. G-2)

39. In Mr. Shipley's opinion, Kodak had no assignable or allocable costs during the years in question as a result of the surplus. Because the pension plan was overfunded, ERISA's "full funding" limitation precluded assigning costs to the period since they were absorbed by the surplus, according to Mr. Shipley. Moreover, he considered that Kodak had no liability with respect to pension costs that could be liquidated. Therefore, the remaining prepayment credits are carried forward (with interest) to be applied in future periods when a liability exists. (Ex. G-1 at 19-21; tr. 28, 134)

40. The only expert accounting witness was Dr. Lane K. Anderson who testified for the Government. Dr. Anderson is the Ernst & Young Professor of Accounting at Texas Tech University and has been a member of the faculty since September 1978 specializing in cost and managerial accounting subjects. He received both an M.B.A. and Ph.D. in Business Administration (Accounting) at the University of Wisconsin-Madison, and a Masters of Accountancy and a B.S. degree (Accounting) from Brigham Young University. He holds a CPA certificate in Utah and a Certified Management Accountant designation from the Institute of Management Accountants. Dr. Anderson has 26 years of Government contract accounting experience. In addition to authoring numerous accounting articles, he is the author or co-author of four books. Two books deal with the accounting for Government contracts and two books are college-level textbooks. (Ex. G-2 at 2-3)

41. Professor Anderson emphasized that Kodak had no "liability" to pay pension costs during the period 1984 through 1986. In the absence of such a "liability" any measured pension costs for the period are not allocable to Government contracts under CAS 412.40(c), in his opinion. According to Professor Anderson, "funding" measured pension costs using prepayment credits does not either create a "liability" or satisfy the "liability" requirement for allocability set forth in that provision. He considers that the requirement is consistent with the CASB's philosophy that the Government should not be required to pay pension costs in excess of its "fair share." Because Government payments

in prior years have contributed to the surplus, the Government should not be required to increase the surplus or make further payments until the contractor is also required, obligated or "liable" to make further payments. (Ex. G-2 at 5-10; tr. 141, 145)

E. Audit Reports; Final Decision and Appeal

42. In early 1989, DCAA commenced audits of Kodak's incurred costs, including pension costs, for the period 1983 through 1986 (JS-34). On 24 September 1990, DCAA issued Audit Report No. 9703-9B140013 (the "September 1990 audit report"), which addressed Kodak's "pension expense incurred and charged to Government contracts" for the period 1984 through 1986. The September 1990 audit report was part of DCAA's final audit of Kodak's overhead submissions to determine Kodak's indirect cost rates for this period. (JS-35) It was DCAA's opinion that, under CAS 412.40(c), Kodak did not have a valid pension cost liability because the pension plan was "fully funded for government contract costing purposes for the subject years." (JS-36)

43. As part of its audit of Kodak's incurred costs for the period 1984 through 1986, DCAA also issued Audit Report No. 09731-92B9200007 on 18 September 1992 (the "September 1992 audit report"), regarding the alleged CAS noncompliance originally raised in the September 1990 audit report. The September 1992 audit report, *inter alia,* stated that Kodak had not complied with its disclosed practices because it did not notify the Government about the change to the PUC method. DCAA "believe[d]" that the cost impact to the Government from this accounting change was about $4.3 million; however, it recommended that Kodak submit a cost impact proposal. (JS-38)

44. The administrative contracting officer (ACO) issued a final determination of noncompliance on 29 June 1994. The final determination asserted that Kodak had failed to (1) notify the Government of a change in cost accounting practice for calculating pension costs; (2) amend its CAS Disclosure Statement to reflect the change in cost accounting practice for calculating pension costs; and (3) treat its pension surplus in accordance with the requirements of CAS 412. The ACO also adopted DCAA's findings that the cost impact of Kodak's alleged noncompliance with the CAS clause and CAS 412 was an increase of $4.3 million in costs allocated to Kodak's Government contracts for the years 1983 through 1986. The ACO instructed Kodak to submit a cost impact statement (JS-41).

45. Kodak concedes that in 1982 it made an undisclosed change in the actuarial method it used to calculate pension costs for Government contract purposes (from FIL to PUC), and that the Government would be entitled to a price adjustment for any increased costs paid by the Government as a result of the undisclosed change in cost accounting practice (JS-42). To determine whether its undisclosed change in cost accounting practice resulted in increased costs paid by the Government, in August 1994 Kodak directed its actuary, Towers Perrin, to recalculate pension costs for 1983 through 1986 using Kodak's disclosed practice, the FIL method (JS-43).

46. In a letter dated 23 December 1994, Kodak responded to the final determination of noncompliance. Kodak informed the ACO, that the Towers Perrin calculations showed that the amount of pension costs calculated and claimed on Government contracts and subcontracts was reduced in the net amount of $5,749,943. The Government benefited from the change, Kodak noted, because the cost savings it realized on Kodak's cost-reimbursement contracts, which comprised about 75 percent of its Government work, exceeded the reduction in cost on Kodak's fixed-price contracts. (JS-44)

47. On 12 January 1998, the ACO issued a final decision determining that Kodak was indebted to the Government for $9,617,856 (consisting of $4,113,491 in pension costs, plus interest of $5,504,365 as assertedly required by CAS), plus interest from the date of the decision until payment was received, on the grounds that (1) Kodak had made a change in its method of accounting for pension costs without disclosing that change to the Government; (2) Kodak's method of accounting for pension costs was noncompliant with CAS 412; or (3) in the alternative, that Kodak improperly had included pension costs that were not allowable under the applicable cost principles in its flexibly-priced contracts during the period at issue (JS-47).

48. On 4 February 1998, appellant filed a timely notice of appeal of the final decision (JS-48).

DECISION

This appeal involves a Government claim for refund of pension costs paid to Kodak for the years 1984 through 1986. The Government primarily argues that the costs are neither assignable nor allocable under CAS 412. During those years, Kodak's pension plan was overfunded but prepayment credits were available for use to the extent that pension costs were properly allocable to cost objectives of the period.

Cost accounting standards have the force and effect of law and, in interpreting the CAS, it is the Board's duty to effectuate the intent of the CASB. To the extent that the CASB's intent may be determined from the plain language and purpose of a standard, it is unnecessary to consult the administrative history of the standard. *See United States v. Missouri Pacific R.R.*, 278 U.S. 269, 277-78 (1929); *Honeywell, Inc. v. United States*, 661 F.2d 182, 186 (Ct. Cl. 1981); *Perry v. Martin Marietta Corp.*, 47 F.3d 1134, 1137 (Fed. Cir. 1995). The Government has the burden of proving that appellant is not in compliance with the CAS. *Ball Corp.*, ASBCA No. 49118, 00-1 BCA ¶ 30,864 at 152,357-58. In this case, the Government has met that burden. We consider that CAS 412 unambiguously requires the existence of a "liability" to fund or liquidate pension costs as a prerequisite to their allocability. Because we conclude that the costs were not allocable, we need not address the numerous issues surrounding the assignability of the costs[2] nor other grounds raised by the Government in support of its claim.

With respect to allocability, the appellant recognizes (through its expert's analysis) that the controlling issue involves interpretation of CAS 412.40(c) (findings 37, 39, 41). The salient sentence of that paragraph states, "Except for pay-as-you-go plans, the cost assignable to a period is allocable to cost objectives of that period to the extent that liquidation of the liability for such cost can be compelled or liquidation is actually effected in that period." The appellant concedes that "liquidation of the liability [can<u>not</u>] be compelled." It agrees that it had no obligation to pay pension costs during the years in question. (*Id*.) Instead, Kodak contends that "liquidation [was] actually effected." Specifically, the appellant asserts that its pension "costs" were actually "paid" or "funded" for the years in question thereby fulfilling the "liquidation" requirement. The "payment" relied on by Kodak is the transfer of its remaining 1982 prepayment into the pension fund. (Findings 19, 20, 25) Kodak stresses the fundamental fairness of permitting allocation of the costs, noting that the large prepayment was made in 1982 and that the remaining funds could not be used for any purpose other than the payment of pension costs. Therefore, Kodak notes that the CASB's intent to restrict the reimbursement of pension costs in circumstances where they might never be paid is not violated because there is no risk that the Government will pay pension costs to Kodak that will never be contributed to the plan. (See finding 37)

As Kodak acknowledges, the critical language relative to allocability is that contained in the second sentence of CAS 412.40(c). The Government contends that the appellant misinterprets that sentence and has no "liability" to pay or fund the costs when the plan is overfunded. We consider that language to be unambiguous and dispositive of this appeal. Under that provision, the essential prerequisite to allocability is the existence of a "liability." In this case, we agree with the Government that the appellant had no liability to further fund its pension plan. Therefore, any assignable pension costs were not properly allocable to cost objectives during the years in dispute.

Appellant concedes that liquidation of any liability could not be compelled. For example, there were no ERISA, contractual or third party obligations (*see* CAS 412.50(c)(2)) that required payment. The Kodak fund's surplus was sufficient to absorb the pension costs computed during the years in dispute. It had no obligation to pay more into a plan that was already overfunded. Nevertheless, appellant alleges that its pension costs are allocable if actually paid even absent a "liability" to pay them.

Kodak's position lacks merit for a number of reasons. Most fundamentally, it emasculates the requirement for a "liability" in CAS 412.40(c). The noun to which the words "liquidation is actually effected" refer is "liability." It is not enough that liquidation of "pension costs" is allegedly effected where there is no underlying obligation or requirement to fund or pay them. Kodak has failed to offer any testimony from an expert accountant that rebuts Professor Anderson's conclusions that a "liability" is fundamentally required and no "liability" exists in this case. (Finding 41) Instead, it attempts to substitute the noun "cost" for "liability." The two nouns are not synonymous in CAS 412. Appellant's reading of this pivotal provision is unreasonable.

The linkage between liability and liquidation is further emphasized in CAS 412.50(c)(4) which states in part, "A liability for pension cost for a cost accounting period . . . shall be considered to be liquidated in the period if funding is effected by the date established for filing a Federal income tax return . . . ." In addition, the distinction between pension costs computed for an accounting period and the allocability of such costs only to the extent that a "liability" exists is reinforced by the "Illustration" at CAS 412.60(c).

Although we need not consult the administrative history of CAS 412 because we find that its plain language precludes allocation to cost objectives of the costs in question, the history of the standard, as reflected in its Preamble, supports our conclusion. The Preamble to CAS 412 (*see* ¶ 11) stresses the need for a "valid liability" before pension costs may be recovered under Government contracts. We also consider that the requirement for a "liability" is consistent with a general policy of CAS 412 as expressed in its Preamble to protect the Government from "making larger reimbursements than is required to defray its fair share of pension costs incurred by contractors" (*see* ¶ 4). Not only is payment of pension costs at the contractor's option or election insufficient under the express language of the standard to warrant their recovery, it also contravenes this general goal.

Kodak's position is premised on what it asserts is the "relatively unique" availability of unused prepayment credits from 1982 (app. reply br. at 54). It agrees that, but for the remaining prepayment and its election to transfer that prepayment into the plan, any properly measured costs assignable to 1984 through 1986 would not be allocable to cost objectives during that period (finding 34). In fact, it makes no claim with respect to the approximately $39.7 million in pension costs it has alleged to be assignable to 1986 over and above the approximate $29 million prepayment credit that remained available for use in that year as computed by Mr. McQuade (finding 33). Nor has it sought recovery of measured pension costs during the entire 1987 to 1995 period when the fund surpluses continued (finding 34). After the prepayments were exhausted in 1986, the appellant agrees that the fund's continuing surpluses properly absorbed its measured pension expenses. In short, Kodak's position is that if "liquidation [of properly measured pension costs] is actually effected" by payment from the prepaid expense account the costs are allocable. The distinction that appellant seeks to make has no basis in the language of CAS 412. Whether the source of the payment is the prepayment account or another Kodak account, a "liability" to pay is a prerequisite to allocability.

The appellant argues that the Government's contentions in this appeal conflict with prior Government positions taken with Kodak as to 1983 and with various Government memoranda and audit reports. Kodak further asserts that even the Government experts in this appeal do not agree.

The merits of appellant's final indirect cost rates for 1983 as settled in 1990 are not before us. There is no contention that the Government is equitably estopped from taking a different position with respect to 1984-1986. With respect to Mr. Shipley's 1983 computations, there is no internal inconsistency. He employed the same general approach in 1983 as he did in 1984 through 1986. After the prepayment and interest equivalents are properly factored out of the asset base, the plan was not overfunded in 1983. In addition, he determined that there was an ERISA liability to pay the computed cost. (Finding 35) Liquidation of that liability could be compelled. Therefore, Mr. Shipley did not question the allocability of the portion of the prepayment that the appellant actually transferred into the fund in 1983. In 1984 to 1986 there was no liability to pay more into the then overfunded plan.

We also do not consider that the Government experts have inconsistent views on the allocability issue. Both Professor Anderson and Mr. Shipley conclude that the pension costs were not allocable to cost objectives during the period in dispute because Kodak had no liability to pay them into the already overfunded plan. Whether the Government experts also agree on the presence in the original CAS 412 of a "full funding limitation" in the measurement and/or assignment process that might also preclude recovery is an issue we need not address given our determinations on the allocability issue.

Kodak also points to various Government memoranda and audit reports of health care providers of record prepared over the last 20 years wherein the appellant alleges that persons within the Government expressed positions that do not comport with those advocated in this appeal. The Government generally denies the inconsistencies, questions the relevance of the documents and counters with allegations that the appellant offered no expert accounting testimony and that Kodak's own CPA firm has expressed opinions that directly conflict with Kodak's current arguments. We have carefully reviewed the referenced documents and find them to be of little, if any, relevance and unpersuasive in resolving this appeal. Extraneous factors and facts are often involved. To the infrequent extent that they unequivocally address issues raised in this appeal, virtually all involve assignment issues that we find it unnecessary to resolve, including the issue of whether a "full funding" limitation was inherent in measuring assignable pension costs using the immediate gain actuarial method under the original CAS 412. The credentials/background of the authors of the Government documents are unknown. The rationale for their conclusions is generally vague and perfunctory.

Appellant contends that the Government's position is "unfair." Kodak maintains that the intent of the CAS is to prevent late funding of pension costs and it is being "penalized" for early funding. The short answer is that the CASB in CAS 412 required this result as detailed above. Moreover, we disagree that the result is "unfair." As emphasized above, CAS 412 was equally concerned about premature funding when no "liability" to pay exists. Imposition of this "liability" test for allocability means neither party must pay more into an overfunded plan. The Government emphasizes that its pre-1984 payments to Kodak contributed to the surplus and, therefore, the Government should be entitled to share proportionately in the benefits of the overfunding to the extent of those payments (*see* finding 41). Mr. McQuade notes that in part the "fairness" issue is one of timing where, as here, there is no evidence that the contractor's universe of flexibly-priced contracts has materially fluctuated from period to period. Mr. McQuade considers that under his measurement/assignment methodology, amortization of alleged "actuarial gains" over a 15 year period gradually credits prior Government contributions to the fund through a reduction of pension costs computed for each period (finding 32). Nevertheless, if Kodak is not obliged to further contribute to its overfunded plan, it is unreasonable to require the Government to pay a share of the unnecessary funding. We also emphasize that Kodak's prepayments are carried forward <u>with</u> interest. They are not lost.[3] (*See* findings 19, 39)

<u>CONCLUSION</u>

We conclude that Kodak's claimed pension costs were not allocable to cost objectives for purposes of Government contracts in 1984 through 1986. Therefore the Government is entitled to a refund of pension costs paid under Government contracts during that period. We remand issues pertaining to the determination of quantum to the parties for negotiation and determination.

The appeal is denied.

Dated: 24 July 2001

ROBERT T. PEACOCK
Administrative Judge
Armed Services Board
of Contract Appeals

I <u>concur</u>

MARK N. STEMPLER
Administrative Judge
Acting Chairman
Armed Services Board
of Contract Appeals

I <u>concur</u>

EUNICE W. THOMAS
Administrative Judge
Vice Chairman
Armed Services Board
of Contract Appeals

NOTES

1 The record includes: the Government Rule 4 (R4) and supplement to the R4 (GSR4); appellant's supplement to the R4 (ASR4); appellant's trial exhibits (A-A through -Q); Government exhibits (G-1 through -3); and the parties' joint stipulation of facts (JS-) dated 12 June 2000. In addition, in accordance with the Board's briefing order of 28 July 2000, the Board has adopted certain admitted findings or portions of findings proposed by the Government (GPF) and appellant (APF).

2 Because it is important to understand and differentiate the assignment issues, which we do not address, from the dispositive allocability issues, we summarize appellant's primary contentions with respect to the measurement/assignment process. With respect to assignment of the pension costs to the years in dispute, Kodak asserts that it followed the "plain language" of CAS 412.40(a)(1) and correctly calculated the four components of pension cost unambiguously identified in that paragraph. According to Kodak, no CAS provision suggests that the "mandatory" rules of CAS 412.40(a)(1) are suspended or superseded for plans using the "immediate gain" (an "accrued benefit") actuarial cost method when the plan is overfunded. The appellant agrees with the Government that CAS 412.50(b)(2)(ii) requires, in the case of plans measuring costs pursuant to a "spread gain" method (used by Kodak prior to 1982), that any otherwise assignable pension cost must be reduced or eliminated to the extent that the pension plan is overfunded. However, the appellant emphasizes that its "immediate gain" method is not covered expressly or implicitly by the CAS 412.50(b)(2)(ii) "exception" and thus no "deviation" from the four-step "general rule" prescribed in CAS 412.40(a)(1) is permitted. Kodak maintains that if a pension plan surplus must be "recognized immediately" regardless of the actuarial cost method used, the CAS 412.50(b)(2)(ii) requirement is redundant and unnecessary. Appellant argues that no other CAS provision and nothing in the regulatory history limits the assignability of pension costs when the plan has a surplus. Following accepted precepts of statutory/regulatory construction, the appellant urges us to infer that the CASB, by specifically imposing the subparagraph 412.50(b)(2)(ii) in "exceptional" circumstances, i.e., when a "spread gain" method is used, did not intend that this "additional" requirement be imposed across the board. Moreover, the appellant asserts that "immediate recognition" of its surplus pursuant to CAS 412.50(b)(2)(ii) and abatement of amortization of actuarial gains would conflict with the 15 year amortization period requirement set forth in CAS 413.50(a)(2). Finally, Kodak notes that CAS 412 was amended in 1995 to impose an "assignable cost limitation" that restricts the assignability of costs in the case of overfunded plans. The appellant concedes that if the current, amended CAS 412

governed this dispute, it would have had no assignable pension costs for the years 1984 through 1986. According to the appellant, however, the standard's amendment indicates that the CASB intended to create new or changed requirements that presumptively were not present under the original, unamended standard in instances where surpluses exist.

[3] Because we resolve this appeal on the basis of the allocability issue, we also need not address whether payments in 1984 through 1986 from the prepayment account into the overfunded plan were reasonably-incurred charges to Government contracts when the contractor had no obligation to contribute further to the plan during that period.

APPENDIX

The pertinent sections of CAS 412 and its preamble, 4 C.F.R. Ch. III, § 412 (1986), as originally promulgated and in effect during the period in dispute stated:

PART 412 – COST ACCOUNTING STANDARD FOR COMPOSITION AND MEASUREMENT OF PENSION COST

. . . .

§ 412.20 Purpose.

The purpose of this Standard is to provide guidance for determining and measuring the components of pension cost. The Standard establishes the basis on which pension costs shall be assigned to cost accounting periods. The provisions of this Cost Accounting Standard should enhance uniformity and consistency in accounting for pension costs and thereby increase the probability that those costs are properly allocated to cost objectives.

§ 412.30 Definitions.

. . . .

(1) *Accrued benefit cost method*. An actuarial cost method under which units of benefit are assigned to each cost accounting period and are valued as they accrue – that is, based on the services performed by each employee in the period involved. The measure of normal cost under this method for each cost accounting period is the present value of the units of benefit deemed to be credited to employees for service in that period. The measure of the actuarial liability at a plan's inception date is the present value of the units of benefit credited to employees for service prior to that date. (This method is also known as the Unit Credit cost method.)

(2) *Actuarial assumption*. A prediction of future conditions affecting pension cost; for example, morality rate, employee turnover, compensation levels, pension fund earnings, changes in values of pension funds assets.

(3) *Actuarial cost method*. A technique which uses actuarial assumptions to measure the present value of future pension benefits and pension fund administrative expenses, and which assigns the cost of such benefits and expenses to cost accounting periods.

(4) *Actuarial gain and loss*. The effect on pension cost resulting from differences between actuarial assumptions and actual experience.

(5) *Actuarial liability*. Pension cost attributable, under the actuarial cost method in use, to years prior to the date of a particular actuarial valuation. As of such date, the actuarial liability represents the excess of the present value of the future benefits and administrative expenses over the present value of future contributions for the normal cost for all plan participants and beneficiaries. The excess of the actuarial liability over the value of the assets of a pension plan is the Unfunded Actuarial Liability.

(6) *Defined-benefit pension 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.

(7) *Defined-contribution pension plan*. A pension plan in which the contributions to be made are established in advance and the benefits are determined thereby.

(8) *Funded pension cost*. The portion of pension costs for a current or prior cost accounting period that has been paid to a funding agency or, under a pay-as-you-go plan, to plan participants or beneficiaries.

. . . .

(11) *Normal cost*. The annual cost attributable, under the actuarial cost method in use, to years subsequent to a particular valuation date.

(12) *Pay-as-you-go cost method*. A method of recognizing pension cost only when benefits are paid to retired employees or their beneficiaries.

. . . .

(14) *Projected benefit cost method*. Any of the several actuarial cost methods which distribute the estimated total cost of all of the employees' prospective benefits over a period of years, usually their working careers.

. . . .

§ 412.40 Fundamental requirement.

(a) *Components of pension cost*. (1) For defined-benefit pension plans, the components of pension cost for a cost accounting period are (i) the normal cost of the period, (ii) a part of any unfunded actuarial liability, (iii) an interest equivalent on the unamortized portion of any unfunded actuarial liability, and (iv) an adjustment for any actuarial gains and losses.

(2) For defined-contribution pension plans, the pension cost for a cost accounting period is the net contribution required to be made for that period, after taking into account dividends and other credits, where applicable.

(b) *Measurement of pension cost*. (1) For defined-benefit pension plans, the amount of pension cost of a cost accounting period shall be determined by use of an actuarial cost method which measures separately each of the components of pension cost set forth in paragraph (a)(1) of this section, or which meets the requirements set forth in § 412.50(b)(2).

. . . .

(c) *Assignment of pension cost*. The amount of pension cost computed for a cost accounting period is assignable only to that period. Except for pay-as-you-go plans, the cost assignable to a period is allocable to cost objectives of that period to the extent that liquidation of the liability for such cost can be compelled or liquidation is actually effected in that period. . . .

§ 412.50 Techniques for application.

. . . .

(7) . . . [I]f a contractor prematurely funds pension costs in a current cost accounting period, the interest earned on such premature funding, based on the valuation rate of return, may be excluded from future years' computations of pension cost made pursuant to this Standard.

. . . .

(b) *Measurement of pension cost*. (1) The amount of pension cost assignable to cost accounting periods shall be measured by the accrued benefit cost method or by a projected benefit cost method which identifies separately normal costs, any unfunded actuarial liability, and periodic determinations of actuarial gains and losses, except as provided in paragraph (b)(2) of this section.

(2) Any other projected benefit cost method may be used, provided that:

(i) The method is used by the contractor in measuring pension costs for financial accounting purposes;

(ii) The amount of pension cost assigned to a cost accounting period computed under such method is reduced by the excess, if any, of the value of the assets of the pension fund over the actuarial liability of the plan as determined by a projected benefit cost method set forth in paragraph (b)(1) of this section;

(iii) The contractor accumulates supplementary information identifying the actuarial gains and losses (and, separately, gains or losses resulting from changed actuarial assumptions) that have occurred since the last determination of gains and losses and the extent to which such gains and losses have been amortized through subsequent pension contributions or offset by gains and losses in subsequent cost accounting periods, and

. . . .

(c) *Assignment of pension cost*. (1) Amounts funded in excess of the pension cost computed for a cost accounting period pursuant to the provisions of this Standard shall be applied to pension costs of future cost accounting periods.

(2) Evidence that the liquidation of a liability for pension cost can be compelled includes (i) provisions of law such as the funding provisions of the Employee Retirement Income Security Act of 1974, except as provided in paragraph (c)(3) of this section, (ii) a contractual agreement which requires liquidation of the liability, or (iii) the existence of rights by a third party to required liquidation of the liability.

. . . .

(4) A liability for pension cost for a cost accounting period (or, for pay-as-you-go-plans, for payments to retirees or beneficiaries for a period) shall be considered to be liquidated in the period if funding is effected by the date established for filing a Federal income tax return (including authorized extensions). . . .

. . . .

§ 412.60 Illustrations.

. . . .

(c) *Assignment of pension cost*. Contractor H has a trusteed pension plan for its salaried employees. It computes $1 million of pension costs for a cost accounting period. Pursuant to the funding provisions of the Employee Retirement Income Security Act of 1974, the company must fund at least $800,000. Because liquidation of the liability for the portion of pension cost required by law to be funded ($800,000) can be compelled, such cost is allocable to cost objectives of the period, in accordance with § 412.40(c). If Contractor H can be compelled by the trustee or the plan participants to fund the remaining $200,000, the liability therefor is also allocable to cost objectives of that period.

. . . .

PREAMBLE A

Original Publication, 9-24-75

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(4) ACTUARIAL COST METHODS

Many commentators expressed their concern over the section of the FEDERAL REGISTER proposal which limited acceptable actuarial cost methods to the accrued benefit cost method or to a projected benefit cost method which separately identifies unfunded actuarial liabilities and actuarial gains and losses. This section, in effect, ruled out the use of an aggregate[6] cost method for measuring pension costs for negotiated Government contracts. Most of these commentators noted that ERISA and APB-8 permit these methods to be used.

[note 6] As used herein, an aggregate cost method is an actuarial cost method which spreads the entire cost of future pension benefits over the average future service lives of the current work force and which does not develop actuarial gains or losses. [end of note 6]

The Board's primary reason for prohibiting the use of an aggregate cost method in the proposed Standard was because such a method does not disclose actuarial gains and losses. Any method that does not disclose actuarial gains and losses impairs the ability to determine whether actuarial assumptions are reasonable. Actuarial assumptions are significant underlying factors for determining the amount of pension costs to be assigned among cost accounting periods. It is only when such assumptions are visible that a determination can be made that they are reasonable. The most appropriate means for determining such reasonableness is to compare assumed events with actual events.

Also, because most aggregate cost methods do not develop unfunded actuarial liabilities, the Government cannot ascertain the funding status of a plan, i.e., whether it is excessively funded at any point in time. Consequently, the Government could be making larger reimbursements than is required to defray its fair share of pension costs incurred by contractors. Many of the comments received acknowledge that most aggregate cost methods do not disclose overfunded situations.

Nevertheless, the Board is impressed by certain of the views of commentators who advocate the use of an aggregate methods. The Board recognizes that aggregate methods are widely used and that they generally spread pension costs evenly and within the periods established in the Standard for amortizing unfunded actuarial liabilities. The Board also notes that commentators stated that a required change in actuarial cost methods may result in substantial actuarial fees and, in some cases, could result in contractors violating current labor commitments.

The Board's solution to this problem was provided generally in several of the comments received. First, several commentators who recognized that an aggregate cost method does not disclose the funding status of a plan, suggested that contractors using such a cost method develop an alternative computation to determine such status. They pointed out that such a computation is required under the full funding limitation of ERISA and is often required by the IRS when it believes a plan may be overfunded.

Other commentators suggested that contractors who use an aggregate cost method provide supplemental information identifying actuarial gains and losses that have occurred and the extent to which such gains and losses have been amortized through subsequent pension contributions or offset by gains and loses in subsequent accounting periods. These commentators informed us that the incremental costs of providing such additional information would be relatively minor.

Accordingly, the Board has added a section (§ 412.50(b)(2)) which permits a contractor to use any projected benefit cost method if the contractor (1) makes an alternative computation (under a projected benefit cost method which separately discloses unfunded actuarial liabilities and actuarial gains and losses) to disclose the funding status of the plan and reduce pension cost as indicated by such computation, (2) provides supplemental information relative to actuarial gains and losses and gains or losses resulting from changed actuarial assumptions, and (3) uses that method in developing costs for financial accounting purposes.

The third requirement was added because the Board has tried unsuccessfully to ascertain criteria for determining the circumstances under which an aggregate cost method is a preferable method for assigning costs to cost accounting periods for Government contracting purposes.

. . . .

(11) ASSIGNMENT OF PENSION COSTS

. . . The concept set forth in the proposal related 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 veiwpoint 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.

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.

In the FEDERAL REGISTER proposal, the Board noted that the requirement to fund a pension cost pursuant to ERISA made the liability valid and therefore made the cost assignable to the current period. . . .

. . . .

I certify that the foregoing is a true copy of the Opinion and Decision of the Armed Services Board of Contract Appeals in ASBCA No. 51326, Appeal of Eastman Kodak Company, rendered in conformance with the Board's Charter.

Dated:

EDWARD S. ADAMKEWICZ
Recorder, Armed Services
Board of Contract Appeals