



UNITED STATES GENERAL ACCOUNTING OFFICE
REGIONAL OFFICE

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GOVERNMENT CENTER

BOSTON, MASSACHUSETTS 02203

September 19, 1975

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Lt. Commander Gary Williams, USN
Chief, Contract Administrative Division
Defense Contract Administration Services Office
Raytheon Company, Spencer Laboratory
Wayside Avenue
Burlington, Massachusetts 01803

Dear Commander Williams:

The General Accounting Office recently completed its review of pension costs allocated to Government contracts at nine contractors from various sections of the United States. The review was made to determine the reasonableness and allocability of pension costs for a recent three-year period. Raytheon Company, Lexington, Massachusetts, was one of the contractors reviewed.

During the course of this review, we presented Raytheon officials with the tentative results. We have now completed our work and are reporting our findings and conclusions for your consideration.

BACKGROUND

Raytheon's pension plans provide coverage for both salaried and hourly employees. Significant features of each plan follow. The salaried plan is contributory, members must be 30 years of age with one year of continuous service or 40 years of age to participate, and 50 percent vesting is obtained after 10 years of continuous service with an additional five percent each succeeding year. Annual benefits are computed based on 60 percent of the member's contributions after 1969, plus a lesser percent for prior years.

The basic hourly plan is non-contributory, membership is obtained upon employment regardless of age; 50 percent vesting is assured after 10 years of credited service with an additional five percent each succeeding year. Monthly benefits are \$6.00 for each year of service after 1972 and somewhat less for prior years. Neither plan provides survivor benefits if a member dies before retirement and neither plan has portability.

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For contracts administered by the Defense Contract Administration Services Region (DCASR), the Administrative Contracting Officer (ACO) is responsible for evaluating pension costs to determine compliance with Armed Services Procurement Regulation. The ACO relies upon the Defense Contract Audit Agency (DCAA) and a DCASR Special Assistant for Contractor Insurance to assist him in evaluating pension costs.

FINDINGS

In summary, we noted that:

- A change in the actuarial method may have increased pension costs charged to Government contracts by an estimated \$1.6 million.
- Past service pension costs for former commercial subsidiaries estimated at \$816,000 are being allocated to Government contracts.
- Raytheon may realize up to \$195,000 as a result of erroneous application of actuarial assumptions.
- Delay in depositing pension contributions could increase pension costs for the Government.

Changing Actuarial Methods May Have Increased Pension Costs Charged to Defense Contracts

ASPR 15.201.3(a) states that: "A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business." What is reasonable depends upon a variety of considerations and circumstances involving both the nature and amount of the cost in question. In determining the reasonableness of a given cost, ASPR states that consideration shall be given to:

"significant deviations from the established practices of the contractor which may unjustifiably increase the contract costs."

In 1970, Raytheon changed actuarial methods--from the accrued benefit cost method to aggregate method without supplemental liability--for its salaried plan. The effect was to accrue more cost in the current year (1970) than would normally have accrued.

Since no actuarial report was prepared for 1970 and the contractor would not provide us the necessary data to determine the effect of the change, we prepared a mathematical model to demonstrate its effect. Based on our model, using the basic benefit formula and the same average age, average years of service and average salary, the change in method increased cost for 1970 from \$916,000 to \$2,872,000 or \$1,956,000. We estimate the effect on Government contract cost to be \$1,626,000.

Because the plan appears to have been overfunded under the accrued benefit cost method, the change may have been made to avoid overfunding and subsequent disallowance by Federal agencies.

Since the actuarial method change was a significant deviation from Raytheon's previous method of calculating annual pension costs, we do not believe the \$1.6 million increase was a reasonable charge to negotiated contracts.

Past Service Pension Costs of Commercial
Subsidiaries Allocated to Government Contracts

D.C. Heath and Caloric companies--wholly owned Raytheon subsidiaries--were members of the Raytheon Salaried Pension Plan but accounted for and reported their pension costs separately. In addition to funding normal cost, the two subsidiaries had an unfunded past service cost which, as of January 1, 1970, was \$614,000.

In October 1970, Raytheon reorganized its corporate structure to include D. C. Heath as a division. In the following year, D.C. Heath pension costs for salaried employees were included as part of Raytheon's normal pension costs. The above costs included a portion of the past service costs for the D.C. Heath Company. Similarly in 1972, Caloric was classified as a division and its pension costs were also included with Raytheon's normal pension costs. Of the 10,513 employees in the plan, 372 were involved in the change.

For 1971 and 1972, past service costs for the former subsidiaries --allocated to Government contracts--totaled about \$88,800. Assuming the continuance of the existing ratio of Government contracts to total Raytheon business, an additional \$727,200 will be absorbed by the Government during the estimated 15-year amortization period.

ASPR contract cost principles cite reasonableness and allocability as the principal factors in determining whether a given cost is allowable. Regarding reasonableness, the costs must be recognized as ordinary and necessary. For the cost to be allocable to Government contracts,

it must be consistent with the relative benefits received and can be distributed to Government and other work in reasonable proportion to the benefits received.

Since D. C. Heath and Caloric companies had, little if any, Government work during the time frame when past service cost accrued, there appears to be no basis to allocate this type cost to Government contracts.

Raytheon officials agree that the past service costs in question are being charged to the Government, but they believe there is an offsetting credit relating to other fringe benefit costs. Specifically, they contend that a greater amount of insurance costs are being absorbed by the commercial subsidiaries as a result of the consolidation. While insurance costs of the former subsidiaries did increase, Raytheon did not demonstrate that these or any related costs were sufficient to offset the amount incurred by the Government for past service costs.

Raytheon May Realize Up to \$195,000 As a Result
Of Erroneous Application of Actuarial Assumptions

Pension costs are predicted on assumptions concerning future occurrences, such as continuance of employment, earnings on funds in the plan or mortality. These assumptions are used when evaluating the financial impact of pension plan benefits and deciding on the appropriate funding (or costing) arrangements to provide for the expenditures a plan will require.

Two assumptions made for 1973 were: (1) salaries will increase at the rate of 4 percent per annum (instead of 3 percent) and (2) the Social Security wage base will increase at an annual rate of 4 percent. Neither of these assumptions were programmed into the actuary's computer and as a result the employer's contribution was overstated by \$534,000. Since Raytheon's sales--applicable to the pension plans in question--was about 83 percent Government, about \$443,000 was allocated to the Government. In January 1974, Raytheon adjusted its accounting records for 1973 costs to reflect this overstatement. Accordingly, all cost-type contracts will have been charged with the correct amount of pension costs. However, fixed price contracts which were awarded before the change was made will not receive the benefit of this adjustment. Since about 44 percent of the dollar value of Government sales were for fixed price contracts, Raytheon may realize up to \$195,000 ($\$443,000 \times 44$ percent), to the extent that the overstatement was used in pricing these contracts.

When Raytheon learned that these actuarial assumptions were overlooked, management had several courses of action available: (1) take the approach actually taken which will result in cost contracts being adjusted, but with no effect on fixed price contracts; (2) handle the transaction as an actuarial gain or loss, similar to that arising from the variation of experience in other actuarial assumptions which would have reduced costs in the following year with the proper credit given to the Government; or (3) issue a credit to the Government.

We believe the transaction should be treated the same as a variation in actual experience and that a contractor should not benefit or lose from errors made by an independent actuary. Raytheon officials did not agree with us and felt that the action taken was reasonable.

Delays in Depositing Pension Contributions Could Increase Pension Costs for the Government

In determining the cost for benefits to be paid under the plan, one of the assumptions made is that the employer's contributions are paid at the beginning of the year. Experience shows the amount for each year is paid approximately a year and a half after the due date provided by valuation.

Since Raytheon receives progress payments for its Government work --which includes a provision for pension costs--the failure to deposit amounts earmarked for pension plans on a timely basis has increased pension costs for subsequent years. For example, if the contributions of 1970-1972, totaling \$17 million, were made quarterly, the related additional earnings of \$1 million (computed at 6 percent) would increase the asset value of the pension fund and accordingly decrease the future years pension cost. Because Government contracts represented about 83 percent of Raytheon's business during this period, the Government's share is \$830,000.

Effective July 25, 1973, the Department of Defense issued Defense Procurement Circular (DPC) 114 which should prevent this from happening in the future. The DPC, which was incorporated as ASPR 7-104.35, effective July 1, 1974, allows pension costs to be included as part of indirect costs for progress payment purposes if contributions are paid within 30 days after the close of each quarter. For the quarter ended December 31, 1973, the pension contribution was due by January 31, 1974. We were advised by DCAA that although Raytheon was tardy with this initial payment, this provision of ASPR has been complied with since April 1974.

In addition, we were unable to ascertain whether Raytheon plans to pay pension contributions for its commercial business in the same manner as its Government work. Since the actuary considers all contributions in determining annual pension costs, any delays with contributions related to their commercial work would increase pension costs for future periods with Government being assessed a proportionate share of such additional costs.

For example, if the actuary determines that annual pension costs are \$5 million and 80 percent of the contractor's business is negotiated with the Government, it is not clear whether Raytheon will pay \$4 or \$5 million to the trustee. If \$4 million is paid on a quarterly basis and the remaining \$1 million is not paid until the following year, future pension costs will increase with about 80 percent being passed on to the Government.

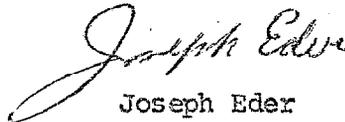
DCAA advised us that Raytheon is making contributions on its total business, therefore, it appears that this provision of ASPR is being properly implemented. Accordingly, this matter is being brought to your attention for your information.

CONCLUSION

In summary, we believe the matters discussed in this report indicate a need for closer surveillance of contractor pension costs by contract administrative and audit activities. We are recommending that your office look into the findings discussed in this report and advise us of your views and any action taken or contemplated within 60 days. We would be glad to discuss this report with you further if you so desire.

Copies of this report are being sent to the Regional Manager of the DCAA regional office.

Sincerely,



Joseph Eder
Regional Manager