Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF UNFUNDED PENSION COSTS OF AETNA LIFE AND CASUALTY COMPANY

JUNE GIBBS BROWN
Inspector General

AUGUST 1998
A-07-98-02506

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Office of Audit Services

Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

CIN: A-07-98-02506

AUG 5 1998

Mr. Terrence E. Keefe, CPA
Manager Medicare Administration, MAA8
Aetna Life and Casualty Company
151 Farmington Avenue
Hartford, Connecticut 06156-7380

Dear Mr. Keefe:

This report provides the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review titled *Review of Unfunded Pension Costs of Aetna Life and Casualty Company*. The purpose of our review was to compute interest on the January 1, 1991 accumulated unfunded pension costs and to determine if pension costs allocable to the Medicare contracts for plan years 1991 through 1995 were funded in accordance with the Federal Acquisition Regulations (FAR).

During our previous review of Aetna Life and Casualty Company (Aetna) (CIN: A-07-93-00679), we determined that the Medicare segment accumulated $4,455,857 in unfunded pension costs as of January 1, 1991. We recommended that Aetna identify those unfunded pension costs as an unallowable component of subsequent years' pension cost calculations. We also recommended that Aetna update the accumulated unfunded pension costs, and identify and track similar costs occurring in later years.

Our current review showed that Aetna did identify and update the accumulated unfunded pension costs from 1991 through 1995. Additionally, Aetna identified and tracked additional unfunded pension costs for years 1991 through 1995. However, we determined that Aetna understated its accumulated unfunded pension costs by $1,407,689 as of January 1, 1996. The understatement occurred because Aetna incorrectly began amortizing the accumulated unfunded costs as a component of the Medicare segment's pension costs in 1995.

We recommend that Aetna increase the January 1, 1996 accumulated unfunded pension costs of the Medicare segment by $1,407,689. We also recommend that Aetna obtain approval of its contracting officer before including any portion of the accumulated unfunded costs as a component of the Medicare segment's pension costs. Aetna agreed with our recommendations and its response is included in its entirety as Appendix B.

INTRODUCTION

BACKGROUND

Cost Accounting Standards (CAS) and FAR

For Medicare reimbursement, pension costs must be (1) measured, assigned, and allocated in accordance with CAS 412 and 413, and (2) funded as specified by part 31 of the FAR. The CAS deals with stability between contract periods and requires that pension costs be consistently measured and assigned to contract periods. The FAR addresses the allowability of pension costs and requires that pension costs assigned to contract periods be substantiated by funding.

The Office of Federal Procurement Policy, Cost Accounting Standards Board, revised the CAS relating to accounting for pension costs on March 30, 1995. Unless otherwise noted, the following references to the CAS refers to the standards that were in effect before the revision. For purposes of clarity, we will refer to the post revision standards as the "revised" CAS. Applicable portions of the revised CAS are discussed in a following section.

The CAS within 48 Code of Federal Regulations (CFR) 9904.412-50(a)(7) stated:

> *If any portion of the pension costs computed for a cost accounting period is not funded in that period, no amount for interest on the portion not funded in that period shall be a component of pension cost of any future cost accounting period.*

In addition, the CAS within 48 CFR 9904.412-50(a)(2) stated:

> *Pension costs applicable to prior years that were specifically unallowable in accordance with then existing Government contractual provisions shall be separately identified and eliminated from any unfunded actuarial liability being amortized....*

Furthermore, the FAR, 48 CFR 31.205-6(j)(3)(i) and (iii), states:

> *...costs of pension plans not funded in the year incurred, and all other components of pension costs...assignable to the current accounting period but not funded during it, shall not be allowable in subsequent years....*

> *Increased pension costs caused by delay in funding beyond 30 days after each quarter of the year to which they are assignable are unallowable.*

Employees Retirement Income Security Act of 1974 (ERISA)

The FAR funding requirement has traditionally been satisfied by trust fund deposits qualifying for tax-exemptions under ERISA. The ERISA provided for a minimum and a maximum deposit to pension funds as determined each year. The minimum represented a required deposit while the maximum represented the upper limit that could be deducted for income tax purposes for the year which the deposit was applicable.

Pension costs computed in accordance with the CAS represented an assignment of pension costs to specific accounting periods. The CAS pension costs often fell between ERISA minimum and maximum contributions. If contractors deposited the minimum ERISA contribution in their qualified trust funds, and the CAS pension costs exceeded the ERISA minimum, the contractors could only claim the funded portion of the CAS amount as allowable contract costs. Additionally, the excess of the CAS costs over the ERISA minimum contribution could not be carried forward as a component of future CAS pension costs.

Conversely, if CAS pension costs before 1986 were greater than maximum ERISA contributions, contractors could deposit the CAS amounts in qualified trust funds, claim them as allowable contract costs, and take ERISA maximums as tax deductions. The excess of the CAS amount over the ERISA maximum could be carried forward to future years for tax deductibility. Similarly, if contractors deposited ERISA maximums that were larger than CAS computed amounts, differences could be carried forward to fund allowable contract costs for future years.

Tax Reform Act of 1986 (TRA 86)

The TRA 86 changed the effect of making pension plan contributions in excess of ERISA maximums. The ERISA maximum was still the tax deductible limit and the excess could still be carried forward to future years for deductibility. However, TRA 86 imposed an excise tax of 10 percent on contributions in excess of ERISA maximums. The excise tax is cumulative from year to year and applied on a first-in/first-out basis considering carry-forwards and current year contributions.

Omnibus Budget Reconciliation Act of 1987 (OBRA 87)

Prior to OBRA 87, ERISA's full funding limitation traditionally considered accumulated assets and the actuarial liability. If assets equaled or exceeded the actuarial liability, the tax deductible amount was limited to zero. With OBRA 87, the Congress took additional action affecting contractors' pension plan contributions to qualified trust funds.

The OBRA 87 imposes a second more restrictive test to the full funding limitation. It considers the accumulated assets and 150 percent of the amount designated "current liability." The actuarial liability under the pre-OBRA 87 test was based on projected benefits and conservative valuation assumptions. The current liability test of OBRA 87 considers only currently accrued benefits and values the liability using interest rates based on Treasury rates. The effect was that most pension plans that were already in full funding would remain there longer. Also, the same effect would push additional plans into full funding.

Revised CAS

As previously noted, the CAS relating to accounting for pension costs was revised on March 30, 1995, and became applicable to contractors with the start of the first accounting period thereafter. The revised CAS removed the regulatory conflict between the funding limits of ERISA and the period assignment provisions of the CAS. The new rule allows the assignment of prior period pension costs, with interest, which were not funded because they lacked tax deductibility. However, the method or methods used to reassign the unfunded pension costs must be approved by the contracting officer.

OBJECTIVE, SCOPE, AND METHODOLOGY

We made our examination in accordance with generally accepted government auditing standards. Our objective was to identify any unfunded CAS costs, plus interest adjustments on the unfunded costs, from January 1, 1991 to January 1, 1996. Our objective also included identifying interest adjustments on the unfunded pension costs previously reported. Achieving our objective did not require that we review the internal control structure of Aetna.

We performed this review in conjunction with our audit of pension segmentation (CIN: A-07-97-02505). The information obtained and reviewed during that audit was also used in performing this review.

The Health Care Financing Administration (HCFA) Office of the Actuary developed the methodology used for computing the CAS pension costs based on Aetna's historical practices.

We performed site work at Aetna's corporate offices in Hartford, Connecticut during October 1997. Subsequently, we performed audit work in our Jefferson City, Missouri office.

FINDING AND RECOMMENDATIONS

As of January 1, 1996, Aetna identified accumulated unfunded pension costs of $8,613,757 related to its Medicare segment. We determined that the Medicare segment's accumulated unfunded pension costs were $10,021,446 as of January 1, 1996. Therefore, Aetna understated the accumulated unfunded pension costs by $1,407,689. This understatement occurred because Aetna incorrectly began amortizing the accumulated unfunded costs as a component of the Medicare segment's pension costs in 1995.

For plan years 1991 through 1994, Aetna did not make contributions to their pension plan. During this period, Aetna correctly identified, tracked and updated the Medicare segment's unfunded pension. As of January 1, 1995 Aetna accurately identified the Medicare segment's accumulated unfunded pension costs as $9,236,358.

For plan year 1995 Aetna made contributions to its pension plan in excess of its 1995 pension costs. The 1995 contributions were sufficient to include an installment towards the accumulated unfunded pension costs. Therefore, Aetna began amortizing the Medicare segment's accumulated unfunded costs as a component of the segment's 1995 pension costs. Aetna amortized the unfunded costs using the methodology set forth in the revised CAS.

The revised CAS does provide for the amortization and assignment of accumulated unfunded pension costs. However, the revised CAS was not effective until March 30, 1995 and did not become applicable until the start of the first accounting period thereafter. Therefore, the revised CAS did not become applicable for Aetna until the beginning of plan year 1996 (January 1, 1996). Additionally, the revised CAS requires that the method or methods used to reassign the unfunded pension costs must be approved by the contracting officer. Aetna did not receive such approval.

We compared CAS pension costs for the Medicare segment, computed by HCFA Office of the Actuary, to actual contributions to the Medicare segment. We found that the Medicare segment had accumulated unfunded pension costs, pus interest, of $10,021,446 as of January 1, 1996. The following table shows the unfunded amounts, and interest on a cumulative basis.

Unfunded CAS Pension Costs and Interest

Plan Year	Unfunded CAS Cost	Interest to January 1, 1996	Total as of January 1, 1996
As of 01/01/91	$4,455,857	$2,337,278	$6,793,135
1991	$1,085,105	$432,589	$1,517,694
1992	$297,914	$84,362	$382,276
1993	$400,764	$71,025	$471,789
1994	$789,449	$67,103	$856,552
1995	$0	$0	$0
Total	$7,029,089	$2,992,357	$10,021,446

Our computation of the unfunded amounts plus interest considers those costs wich should have been funded for the applicable years. In other words, if Aetna funded the costs, the assets of the Medicare segment would have been greater. Appendix A provides additional information on the CAS pension costs.

Recommendations

We recommend that Aetna:

- ❶ Increase the accumulated unfunded pension costs of the Medicare segment by $1,407,689 as of January 1, 1996.

- ❷ Obtain approval from its contracting officer before including any portion of the accumulated unfunded pension costs as a component of the Medicare segment's CAS pension costs.

Auditee Response

Aetna agreed with our recommendations.

INSTRUCTIONS FOR AUDITEE RESPONSE

Final determinations as to actions to be taken on all matters reported will be made by the HHS action official identified below. We request that you respond to the recommendation in this report within 30 days from the date of this report to the HHS action official, presenting any comments or additional information that you believe may have a bearing on final determination.

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), OIG, OAS, reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR Part 5).

Sincerely,

Barbara A. Bennett

Barbara A. Bennett
Regional Inspector General for
Audit Services, Region VII

Enclosures

HHS Action Official:

Ms. Judy Berek
Acting Regional Administrator, Region I
Health Care Financing Administration
John F. Kennedy Federal Building, Room 2325
Boston, Massachusetts 02203-0003

AETNA LIFE AND CASUALTY COMPANY
CIN: A-07-98-02506

STATEMENT OF CAS PENSION COSTS AND FUNDING
JANUARY 1, 1991 TO JANUARY 1, 1996

	Description		Total Company	Other Segment	Medicare Segment
01/01/91	Normal Cost	1/	$46,417,667	$45,157,849	$1,259,818
01/01/91	Amortization Payment	2/	($23,972,246)	($23,707,937)	($264,309)
01/01/91	CAS Pension Cost	3/	$22,445,421	$21,449,912	$995,509
	Interest to 12/31//91	4/	$2,020,088	$1,930,492	$89,596
12/31/91	CAS Funding Target	5/	$24,465,509	$23,380,404	$1,085,105
	Contribution	6/	$0	$0	$0
	Interest to 12/31/91	7/	$0	$0	$0
12/31/91	Under (Over) Funding	8/	$24,465,509	$23,380,404	$1,085,105
01/01/92	Normal Cost		$44,063,403	$42,859,086	$1,204,317
01/01/92	Amortization Payment		($25,215,566)	($24,284,565)	($931,001)
01/01/92	CAS Pension Cost		$18,847,837	$18,574,521	$273,316
	Interest to 12/31//92		$1,696,305	$1,671,707	$24,598
12/31/92	CAS Funding Target		$20,544,142	$20,246,228	$297,914
	Contribution		$0	$0	$0
	Interest to 12/31/92		$0	$0	$0
12/31/92	Under (Over) Funding		$20,544,142	$20,246,228	$297,914

AETNA LIFE AND CASUALTY COMPANY
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STATEMENT OF CAS PENSION COSTS AND FUNDING
JANUARY 1, 1991 TO JANUARY 1, 1996

	Description	Total Company	Other Segment	Medicare Segment
01/01/93	Normal Cost	$43,223,454	$42,028,119	$1,195,335
01/01/93	Amortization Payment	($26,432,802)	($25,605,140)	($827,662)
01/01/93	CAS Pension Cost	$16,790,652	$16,422,979	$367,673
	Interest to 12/31//93	$1,511,159	$1,478,068	$33,091
12/31/93	CAS Funding Target	$18,301,811	$17,901,047	$400,764
	Contribution	$0	$0	$0
	Interest to 12/31/93	$0	$0	$0
12/31/93	Under (Over) Funding	$18,301,811	$17,901,047	$400,764
01/01/94	Normal Cost	$60,757,072	$59,001,870	$1,755,202
01/01/94	Amortization Payment	($38,385,778)	($37,358,179)	($1,027,599)
01/01/94	CAS Pension Cost	$22,371,294	$21,643,691	$727,603
	Interest to 12/31//94	$1,901,560	$1,839,714	$61,846
12/31/94	CAS Funding Target	$24,272,854	$23,483,405	$789,449
	Contribution	$0	$0	$0
	Interest to 12/31/94	$0	$0	$0
12/31/94	Under (Over) Funding	$24,272,854	$23,483,405	$789,449

AETNA LIFE AND CASUALTY COMPANY
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STATEMENT OF CAS PENSION COSTS AND FUNDING
JANUARY 1, 1991 TO JANUARY 1, 1996

	Description	Total Company	Other Segment	Medicare Segment
01/01/95	Normal Cost	$59,838,099	$58,068,293	$1,769,806
01/01/95	Amortization Payment	($35,921,431)	($34,911,712)	($1,009,719)
01/01/95	CAS Pension Cost	$23,916,668	$23,156,581	$760,087
	Interest to 12/31//95	$2,032,917	$1,968,310	$64,607
12/31/95	CAS Funding Target	$25,949,585	$25,124,891	$824,694
	Contribution	($154,475,090)	($153,650,396)	($824,694)
	Interest to 12/31/95	$0	$0	$0
12/31/95	Under (Over) Funding	($128,525,505)	($128,525,505)	$0

FOOTNOTES

1/ We obtained the total company and Medicare segment normal cost from Aetna's actuarial valuation reports. The amount shown for the "other segment" represents the difference between the total company and the Medicare segment.

2/ We based the amortization payment on a CAS amortization schedule developed from information obtained from Aetna's valuation reports. The amortization payment was negative for years in which pension assets exceeded actuarial liabilities, thereby creating a negative unfunded actuarial liability.

3/ The CAS pension cost represents the sum of the amortization payment and the normal cost. We separately calculated the Medicare segment's CAS pension costs for all years 1991 through 1995.

4/ We applied one year's interest at the assumed rate of 9.0 percent for years 1991 through 1993, and 8.5 percent for years 1994 and 1996. We obtained the interest rates from the actuarial valuation reports.

AETNA LIFE AND CASUALTY COMPANY
CIN: A-07-98-02506

STATEMENT OF CAS PENSION COSTS AND FUNDING
JANUARY 1, 1991 TO JANUARY 1, 1996

5/ The annual CAS pension cost, adjusted with interest to the end of the year, must be funded by current and prepaid contributions to satisfy the allowability criteria of FAR, section 31.205-6(j).

6/ Aetna did not make contributions to its pension plan for plan years 1991 through 1994. However, it did make a contribution for plan year 1995. We assigned contributions to the Medicare segment based on the segment's CAS funding target.

7/ We calculated interest on the contributions, from the date of deposit to the end of the year, at the assumed rates of interest (see footnote 4/). Contributions made after the end of the year were deemed to have been made on the last day of the year, and accordingly accrued no interest.

8/ The unfunded pension cost represents the CAS funding target less the value of contributions. A prepayment credit is created for years in which contributions are made in excess of the CAS funding target. The prepayment credit is carried forward and applied towards the funding of future CAS pension costs.

Aetna

Terrence E. Keefe C.P.A.
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July 14, 1998

Ms. Barbara A. Bennett
Regional Inspector General for Audit Services
Region VII
801 East 12th Street
Room 284A
Kansas City, Missouri 64106

RE:CIN: A-07-97-02505
CIN: A-07-98-02506

Dear Ms. Bennett,

I have reviewed your draft audit reports dated January 21, 1998, entitled *Review of Medicare Contractor's Pension Segmentation, Aetna Life and Casualty Company*, and *Review of Unfunded Pension Costs of Aetna Life and Casualty Company*, for the period January 1, 1991 to January 1, 1996, and concur with the results of the audit. I have no additional comments to make concerning the report.

Sincerely,

Terrence E. Keefe

Terrence E. Keefe
Manager
Medicare Administration, MC54
Aetna Life Insurance Co.

c: Gregory A. Tambke, OIG, Jefferson City
William G. Young, Hewitt Associates, LLC