Memorandum

Date MAY -9 2002

From Thomas D. Roslewicz
Deputy Inspector General
for Audit Services

Subject Audit of the Post Retirement Benefit Costs Claimed by Transamerica Occidental Life Insurance Company (A-07-02-03007)

To Neil Donovan
Director, Audit Liaison Staff
Centers for Medicare & Medicaid Services

As part of an ongoing collaborative effort between the Office of Inspector General and the Centers for Medicare & Medicaid Services (CMS), we are alerting you to the issuance within 5 business days from the date of this memorandum of our final report entitled, "Audit of the Post Retirement Benefit Costs Claimed by Transamerica Occidental Life Insurance Company." A copy of the report, identifying about $3.1 million in post retirement benefit (PRB) costs unallowable for Medicare reimbursement, is attached.

We suggest that you share this report with CMS components involved with monitoring the Medicare contractor financial operations, particularly the Office of Financial Management, the Center for Medicare Management, and the Office of the Actuary.

The Transamerica Occidental Life Insurance Company (TOLIC) was a Medicare contractor until its contract was terminated in 2000 and, as such, was allowed to claim Medicare reimbursement for its Medicare employees' PRB costs. However, regulations provide that, to be allowable, PRB costs must be funded by the time set for filing the Federal income tax return or any extension thereof. The PRB costs assigned to the current year, but not funded by the tax return time, are not allowable in any subsequent year. Since TOLIC's claim was based on unfunded costs, we are recommending that TOLIC withdraw its claim of approximately $3.1 million for PRB costs.

The TOLIC did not agree with the amount of the PRB claim included in our report, nor did it believe that the Federal Acquisition Regulations governed its PRB claim. We disagree with TOLIC's assertions and found nothing in TOLIC's response to cause us to change our opinion.

If you need additional information about this report, please contact George M. Reeb, Assistant Inspector General for Health Care Financing Audits, at (410) 786-7104 or James P. Aasmundstad, Regional Inspector General for Audit Services, Region VII, at (816) 426-3591.

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

AUDIT OF THE POST RETIREMENT BENEFIT COSTS CLAIMED BY TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY

DEPARTMENT OF HEALTH & HUMAN SERVICES · USA

JANET REHNQUIST
Inspector General

MAY 2002
A-07-02-03007

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

MAY 14 2002

CIN: A-07-02-03007

Mr. James W. Dederer
Executive Vice President and General Counsel
Transamerica Occidental Life Insurance Co.
1150 South Olive
Los Angeles, California 90015

Dear Mr. Dederer:

This report provides you with the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review entitled, ***Audit of the Post Retirement Benefit Costs Claimed by Transamerica Occidental Life Insurance Company***. The purpose of our review was to determine the allowability of $3,060,873 in post retirement benefit (PRB) costs claimed for Medicare reimbursement by Transamerica Occidental Life Insurance Company (TOLIC). The $3,060,873 represents PRB costs that will be incurred subsequent to the termination of TOLIC's Medicare contract.

The review showed that the claimed costs are unallowable for Medicare reimbursement and we recommend that TOLIC withdraw the claim. The TOLIC disagreed with our calculation of the PRB costs and with the allowability of these costs. The TOLIC's response is included in its entirety (less attachments) as Appendix A. Appendix B contains the Centers for Medicare & Medicaid Services (CMS), (formerly Health Care Financing Administration), Office of the Actuary's comments on TOLIC's response.

INTRODUCTION

BACKGROUND

The TOLIC administered Medicare Part B operations under a cost reimbursement contract until the contractual relationship was terminated effective November 30, 2000. Contractors were to follow cost reimbursement principles contained in the Cost Accounting Standards, the Federal Acquisition Regulations (FAR), and their Medicare contracts.

The FAR sets forth the allowability requirements and applicable methods of accounting for PRB costs under a Government contract. The PRB costs can include, but are not limited to, post retirement health care; life insurance provided outside a pension plan; and other welfare benefits such as tuition assistance, day care, legal services, and housing subsidies provided after retirement. The PRBs do not cover cash and life insurance paid by pension plans during the period following the employees' retirement.

According to FAR 31.205-6(o)(2), PRB costs can be calculated using one of the following:

- **Cash Basis** (or pay-as-you-go) - recognizes costs as PRBs when they are actually provided.

- **Terminal Funding -** accrues and pays the entire PRB liability to the insurer or trustee in a lump sum upon the termination of employees to establish and maintain a fund or reserve for the purpose of providing PRBs to retirees. The lump-sum payment is allowable if amortized over a period of 15 years.

- **Accrual Basis -** measures and assigns costs according to generally accepted accounting principles and pays an insurer or trustee to establish and maintain a fund or reserve for the sole purpose of providing PRBs to retirees. The accrual must be calculated in accordance with generally accepted actuarial principles and practices as promulgated by the Actuarial Standards Board.

The FAR further states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof. The PRB costs assigned to the current year, but not funded by the tax return time, are not allowable in any subsequent year.

In 1990, the Financial Accounting Standards Board issued the Statement of Financial Accounting Standard (SFAS) 106 which established accounting standards for PRBs. The SFAS 106 significantly changed the practice of accounting for PRBs from the cash basis to the accrual basis only.

With the implementation of SFAS 106, companies are required to report in their financial statements the accrued liability for PRBs for current and retired employees. The SFAS 106 requires the annual reporting of net periodic service costs, as well as a transition obligation (i.e., a cumulative effect of an accounting change) which may be recognized either immediately or amortized on a straight line basis over the average remaining service of active plan participants.

The FAR allows contractors the option of electing SFAS 106 accrual accounting for funded PRBs, or of continuing to recognize PRB costs on the cash basis for Government contract purposes if that had been their practice. However, the FAR does not allow contractors to immediately recognize any SFAS 106 transition obligation. The FAR provides for recognition on an amortized basis.

Medicare contractors were alerted to the SFAS 106 requirements and the FAR options by instructions in the Budget and Performance Requirements for Fiscal Year 1993. The TOLIC chose to continue using the cash basis for its Government contracting purposes and, thus, recognize PRB costs when they were actually provided.

OBJECTIVES, SCOPE, AND METHODOLOGY

At the request of CMS, we audited TOLIC's August 1, 2001 claim of $3,060,873 for PRB costs to be incurred subsequent to the termination of the Medicare contract.

We performed our audit in accordance with generally accepted government auditing standards. The objective of our audit was to determine whether PRB costs claimed for the period subsequent to TOLIC's termination were allowable for Medicare reimbursement. Achieving our objective did not require that we review TOLIC's internal control structure.

This review was done in conjunction with our audit of pension segmentation for a terminated contractor (A-07-01-00125). The information obtained and reviewed during that audit was also used in performing this review.

In performing our review, we used information as presented in TOLIC's Termination Cost Voucher, which included support provided by TOLIC's consulting actuaries. We examined TOLIC's PRB claim in relation to applicable laws and regulations to determine whether TOLIC complied with regulatory requirements.

We conducted our review at TOLIC and at our OIG, OAS Jefferson City, Missouri field office.

FINDINGS AND RECOMMENDATION

The TOLIC claimed $3,060,873 in PRB costs that are unallowable for Medicare reimbursement. The $3,060,873 represents costs for PRBs that TOLIC estimates will be incurred after the termination of its Medicare contracts. The claim represented: (1) a retroactive change in accounting basis with immediate recognition of the transition obligation, and (2) a request for reimbursement of unfunded costs. None of these costs are allowable in accordance with the FAR and, therefore, the costs are unallowable for Medicare reimbursement.

The TOLIC's contractual relationship under Medicare was terminated in 2000. On August 1, 2001, TOLIC claimed $3,060,873 to cover PRBs to be paid subsequent to the contract completion date. The FAR allows contractors the option of electing SFAS 106 accrual accounting, but it requires the amortization of the transition obligation amount. Additionally, the FAR states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof.

The TOLIC's normal practice for Government contracting purposes has been to claim PRB costs on the cash basis. On this basis, TOLIC would have been reimbursed for actual PRB costs incurred through the contract termination date. The TOLIC's subsequent claim for PRB costs was calculated using an accrual basis considering the immediate recognition of the entire transition obligation amount.

The PRB claim is based on the retroactive changing from a cash basis to an accrual basis for claiming PRB costs subsequent to its contract termination. In addition to being a retroactive change, TOLIC's application of the SFAS 106 accrual method of accounting for PRBs is not in compliance with the FAR with regard to treatment of a transition obligation. Furthermore, although TOLIC's claim is based on the accrual method, TOLIC has not established a fund or reserve to provide PRBs to retirees. Therefore, TOLIC is claiming reimbursement for unfunded costs.

Accordingly, we concluded that PRB costs of $3,060,873 claimed by TOLIC are unallowable for Medicare reimbursement and we are recommending that TOLIC withdraw the claim.

RECOMMENDATION

We recommend that TOLIC withdraw the August 1, 2001 claim of $3,060,873 for PRB costs.

Auditee's Comments

The TOLIC disagreed with our report. The TOLIC's assertions and opinions are summarized in the following paragraphs and presented in detail in Appendix A.

The TOLIC contends that it did not claim $3,060,873 in PRB costs, as noted in our report. Instead, TOLIC believes it only claimed $2,900,000, as evidenced by its Termination Cost Voucher dated August 1, 2001. The TOLIC claims that the $160,873 difference represents a balance due from a prior voucher and that this amount was not included in its request to CMS for reimbursement of the PRB costs.

The TOLIC believes that its claim is not governed by FAR 31.205-6(o) since the FAR does not address the accounting for PRB costs in contract termination or segment closing situations. The TOLIC also asserts that the need to recognize these unfunded PRB costs results from the termination of the contract and the decision to close the segment. As a result, TOLIC believes that the contract termination justifies its change in accounting basis.

OIG's Response

We disagree with TOLIC's assertion that TOLIC claimed $2,900,000 in PRB costs and not the $3,060,873 noted in our report. We also disagree with TOLIC regarding the allowability of its PRB costs. Our reasons for disagreeing are summarized in the following paragraphs. The CMS, Office of the Actuary's detailed comments on TOLIC's response are presented in Appendix B.

The $2,900,000 that TOLIC asserts was claimed as PRB costs can be found on their Termination Cost Voucher dated August 1, 2001. The same Termination Cost Voucher also includes costs for Supplemental Employee Retirement Plan (SERP), as well as a balance due from a prior voucher. The total of these three items was $3,241,117. In addition to their Termination Cost Voucher, TOLIC included a July 31, 2001 letter to CMS requesting reimbursement for PRB and

SERP costs in the amount of $3,241,117. Since the total of the Termination Cost Voucher agrees with the requested reimbursement amount in the letter to CMS, TOLIC's assertion that they only claimed $2,900,000 in PRB costs is not valid.

The TOLIC's Medicare contract requires that the costs allowable and allocable for administration of the contract be determined in accordance with provisions of part 31 of the FAR. The FAR 31.205-6(o)(2) sets forth the allowability requirements and applicable methods of accounting for PRB costs. The FAR states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof. The PRB costs assigned to the current year, but not funded by the tax return time, are not allowable in any subsequent year. We did not find any provisions in the FAR that indicated it would not apply to contract terminations. Therefore, the PRB costs of $3,060,873 claimed by TOLIC are unallowable for Medicare reimbursement.

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, 5 U.S.C. 552, as amended by Public Law 104-231, OIG, OAS reports are made available to the public to the extent information contained therein is not subject to exemptions in the Act. (See CFR part 5.) As such, within 10 business days after the final report is issued, it will be posted on the worldwide web at **http://oig.hhs.gov/**.

Sincerely,

James P. Aasmundstad

James P. Aasmundstad
Regional Inspector General for
Audit Services, Region VII

Enclosures

HHS Action Official:

Ms. Elizabeth Abbott
Regional Administrator, Region IX
Centers for Medicare & Medicaid Services
75 Hawthorne Street, 4th Floor
San Francisco, California 94105-3903

APPENDICES

POWELL
GOLDSTEIN
FRAZER &
MURPHY LLP

Transamerica Occidental Life Insurance Company's

Response

to the

Department of Health and Human Services,

Office of Inspector General, Office of Audit Services

Draft Report Entitled:

Post Retirement Benefit Costs Claimed by

Transamerica Occidental Life Insurance Company,

Dated December 2001

W. Bruce Shirk
Mary Baroody Lowe

Powell, Goldstein, Frazer & Murphy LLP
1001 Pennsylvania Ave., NW
Sixth Floor
Washington, DC 20004
Tel: (202) 347-0066
Fax: (202) 624-7222

Dated: February 14, 2002

TABLE OF CONTENTS

Transamerica Occidental Life Insurance Company's
Response to the Draft Report Entitled
Post Retirement Benefit Costs Claimed by
Transamerica Occidental Life Insurance Company,
Dated December 2001

I. Introduction 1

II. TOLIC's Claimed PRB Costs Should be Allowed as a Part of the Termination Settlement Because They Are Properly Accounted for in the Period of the Termination 1

A. FAR 31.205-6 Specifically Permits the Cash Basis of Accounting for Post-Retirement Benefits in Ongoing Contract Situations, But Clearly Does Not Apply to Contract Termination or Segment Closing Situations 2

1. FAR 31.205-6 By Its Own Language Clearly Applies Only to Accounting for Periodic, or Ongoing, Costs 2
2. GAAP Provides the Required Basis of Accounting in Contract Termination Involving a Pay-As-You-Go PRB Plan 2
3. Since the Post-Retirement Benefit Costs Were an Unfunded Liability, TOLIC Was Not Required to Recognize These Costs Prior to the Termination 3
4. The Existing Far Provision Relating to Accounting for Post-Retirement Costs, FAR 31.205-6(o), Does Not Apply to Contract Termination Situations 3
5. Since the FAR Does Not Address Accounting for Post-Retirement Benefits in a Contract Termination Situation, GAAP Principles SFAS 106 and APB Opinion 30 Apply 5

B. FAR 31.204(c) Also Supports the Conclusion that Unfunded Post-Retirement Benefit Costs Liability Is Properly Recognized in the Cost Accounting Period of the Termination 6

C. TOLIC Has Recognized $2,900,000 as the Post-Retirement Benefits Liability Directly Associated with Former Employees of the Medicare Segment 7

III. Conclusion 7

EXHIBIT LIST

Transamerica Occidental Life Insurance Company
For Response to the Draft Report Entitled

Post Retirement Benefit Costs Claimed by
Transamerica Occidental Life Insurance Company,
Dated December 2001

Exhibit A – TOLIC Post-Retirement Benefit Costs Comparison Chart
Exhibit B – Termination Cost Voucher (Aug. 1, 2001)
Exhibit C – Hewitt Associates, LLC Final Welfare Valuation With Breakout (April 9, 2001)
Exhibit D – Cost Accounting Standards Board, 61 Fed. Reg. 49,537-49,538 (Sept. 20, 1996)
Exhibit E – GAO Report No. GAO/AIMO-94-88, Cost Accounting Standards Board, "Little Progress Made in Resolving Important Issues" (May 1994)
Exhibit F – Hewitt Associates FAS 106 Evaluation as of Jan, 1, 2000

Transamerica Occidental Life Insurance Company's
Response to the Draft Report Entitled

Post Retirement Benefit Costs Claimed by
Transamerica Occidental Life Insurance Company,
Dated December 2001

by the

Office of Inspector General, Office of Audit Services
of the Department of Health and Human Services

February 14, 2002

Reference: CIN A-07-02-03007

I. Introduction

Transamerica Occidental Life Insurance Company ("TOLIC") claimed $2,900,000 in Post Retirement Benefit ("PRB") costs that it anticipates it will be obligated to pay following contract termination on November 30, 2000. Under the applicable Cost Principles and Generally Accepted Accounting Principles ("GAAP"), SFAS 106 and APB Opinion 30, the PRB costs claimed are properly recognized in the cost accounting period of the termination and therefore are allowable. (Exhibit A.) For this reason, TOLIC believes the costs should be allowable and paid as part of TOLIC's contract termination costs.

II. TOLIC's Claimed PRB Costs Should Be Allowed as a Part of the Termination Settlement Because They Are Properly Accounted for in the Period of the Termination

The Office of Inspector General ("OIG") maintains that the PRB costs that TOLIC estimates will be incurred subsequent to the termination of TOLIC's Medicare contract are unallowable because the claim represents: "(1) a retroactive change in accounting basis with immediate recognition of the transition obligation, and (2) a request for reimbursement of unfunded costs." (See Department of Heath and Human Services, Office of Inspector General draft report entitled "Post Retirement Benefit Costs Claimed By Transamerica Occidental Life Insurance Company," dated December 2001, at 3 (hereafter "OIG PRB Rep.").)

As an initial matter, TOLIC questions the OIG's assertion that $3,060,873 in PRB costs are at issue. (OIG PRB Rep. at 1.) TOLIC claimed $2,900,000, not $3,060,873, in PRB costs, as is evidenced by the Termination Cost Voucher submitted to the government on July 1, 2001. (Exhibit B.) An outside actuarial firm, Hewitt Associates LLC, determined that this is the value of the Medicare segment liability which TOLIC has accrued. (Exhibit C.)

Second, TOLIC disagrees with the OIG's conclusion that PRB costs are unallowable. Under the applicable regulations, the measurement and recognition of the TOLIC PRB costs given the termination of the Medicare Part B contract is not a "retroactive change in accounting basis" for the reasons presented below.

A. FAR 31.205-6 Specifically Permits the Cash Basis of Accounting for Post-Retirement Benefits in Ongoing Contract Situations, But Clearly Does Not Apply to Contract Termination or Segment Closing Situations

1. FAR 31.205-6 By Its Own Language Clearly Applies Only to Accounting for Periodic, or Ongoing, Costs

The specific criteria to determine the allowability of the cost of post-retirement benefits other than pensions are set out in FAR 31.205-6. Prior to 1991, the cost principles did not contain specific allowability criteria for the cost of post retirement benefits other than pensions. In 1991, Paragraph "o" was added to FAR 31.205-6 in part to address the accounting practices in Financial Accounting Standards Board (FASB) Statement 106. FAR 31.205-6 does not apply to accounting for post-retirement benefits in contract termination or segment closing situations.

FAR 31.205-6(o) specifically permits the cash basis of accounting for government contract costs incurred. The costs of the TOLIC plan were incurred pursuant to an established policy of the contractor. In addition, the costs of these benefits have been accepted by the government, and, thus, deemed reasonable over the years.

The accrual basis of accounting criteria in FAR 31.205-6(o), however, clearly apply to accounting for periodic, or ongoing, costs, and not to accounting for a contract termination or segment closing. FAR 31.205-6(o) references the requirements of GAAP, embodied in Statement of Financial Accounting Standard (SFAS) 106, and more particularly, SFAS 106 Paragraphs 110, 112, and 113. These Paragraphs specifically recognize: (i) a "transition liability" – the unfunded liability for post-retirement benefits, (ii) provide for recognition of that liability "… on a delayed basis (Paragraph 112) as a component of net periodic post-retirement benefit costs" (Paragraph 110), (iii) the amortization of the "transition liability," and (iv) the circumstances when the amortization shall be accelerated (Paragraph 112). Thus, the express language of SFAS 106, Paragraph 112 indicates that these provisions deal with determining "periodic" costs. Periodic costs are the ongoing costs for each cost accounting period the segment is operating as opposed to the situation in this case, the contract termination and/or the closing of a segment.

2. GAAP Provides the Required Basis of Accounting in Contract Termination Involving a Pay-As-You-Go PRB Plan

TOLIC's Medicare Part B contract was terminated effective November 30, 2000. As discussed in the sections that follow, in those instances where neither the CAS nor the FAR specifically govern the required accounting for a contract termination and/or segment closing involving a pay-as-you-go post-retirement plan, the applicable GAAP provides the required basis of accounting. The applicable GAAP provisions are SFAS 106, Paragraphs 112 and 103, and APB Opinion 30. Under either the acceleration requirement of SFAS 106, Paragraph 112, or the explicit requirement of SFAS 106, Paragraph 103—which deals with discontinued operations, such as a segment closing—recognition in the cost accounting period of the termination of the remaining unfunded liability for the post-retirement benefits plan satisfies the FAR cost measurement requirement for allowable cost. (These are discussed in detail below.)

3. Since the Post-Retirement Benefit Costs Were an Unfunded Liability, TOLIC Was Not Required to Recognize These Costs Prior to the Termination

The recognition of post-retirement benefit costs for government contract purposes is based on obligations arising from employee services in past and current periods. This relationship is the beneficial or causal relationship used for determining the cost accounting period for recognition of these costs. The relationship is defined by the requirements of CAS, FAR, or GAAP as provided in the relevant FAR requirements. The post-retirement benefit costs and liabilities at issue in the present case arose under the current and prior Medicare Part B contracts. Under the applicable government contract accounting requirements, TOLIC was not required to recognize these unfunded liabilities as costs before the termination of the contract or the closing of the TOLIC segment. TOLIC was under no obligation to recognize these liabilities because, for the continuing operations of TOLIC, the post-retirement benefit costs were being recorded and allocated to the government contracts using the pay-as-you-go method.

The required accounting for the unfunded post-retirement benefit costs when a contractor is using a pay-as-you-go method and a contract is terminated, accompanied by the closure of a segment, is not specifically covered in either the CAS or FAR requirements applicable to the current contract.

With respect to CAS, the Cost Accounting Standards Board on September 20, 1996 published a "Staff Discussion Paper on the Treatment of Costs of Post-Retirement Plans Other than Pension Plans Sponsored by Government Contractors." 61 Fed. Reg. 49,534 (Sept. 20, 1996). The paper, along with a GAO report cited therein, recognizes that the current Standards do not specifically cover these costs and, therefore, the need for work to address accounting for these costs. (*See* 61 Fed. Reg. 49,534, 49,537 at Topic A (Exhibit D); United States General Accounting Office, Report No. GAO/AIMD-94-88, Cost Accounting Standards Board, *Little Progress Made in Resolving Important Issues* 1, 7 (figure 2) (May 1994) (Exhibit E).)

4. The Existing FAR Provision Relating to Accounting for Post-Retirement Costs, FAR 31.205-6(o), Does Not Apply to Contract Termination Situations

The existing FAR coverage for post-retirement benefit costs, other than pensions, is found in FAR 31.205-6 (o). This paragraph was initially established on June 25, 1991 in FAC 90-5, 56 Fed. Reg. 29,124. It was amended on August 22, 1991 in FAC 90-7, 56 Fed. Reg. 41,738. FAR 31.205-6(o) does not apply to a contract termination or segment closing situation.

For example, the August 1991 FAC points out in its introductory comments, Item 9, that "the new paragraph places a limit on the allowable amount of post-retirement benefit transition costs which may be recognized or amortized in a fiscal period." This language, which limits the amount of costs to be recognized based on an amortization measurement, clearly indicates that it is a measurement of continuing costs over an expected period of future operations. It is not a provision that deals with a situation in which there are no expected periods of future operations.

In fact, this distinction is clearly recognized in SFAS 106 "Employers Accounting for Post-Retirement Benefits Other than Pension." Paragraphs 113 and 114 of SFAS 106 require that the transition obligation be amortized over a period of 20 years and provide for certain adjustments to the amount in any given period. Again these provisions of SFAS 106 are used in circumstances in which there are costs to be recognized over the continuing operations and life of the plan.

Paragraph 103 of SFAS 106 specifically provides accounting requirements for the situation in which a segment is disposed of; that is a different circumstance from when a segment and its related post-retirement benefit plan have a continuing life. The accounting in the circumstances of a disposal of a segment is governed by the requirements of APB Opinion 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequent Occurring Events and Transactions" and SFAS 106.

Further support for the position that the provisions of FAR 31.205-6 (o) do not apply to a contract termination and/or segment closing situation, but rather are limited to determining the cost for ongoing operations and related plans, is provided by the CASB Staff Discussion Paper of September 20, 1996. In that Staff Discussion Paper, nowhere is there reference made to any provision of the FAR or CAS covering the accounting requirements for unfunded post-retirement benefit costs in the case of a contract termination and/or segment closing.

In fact, under Topic I "Accounting for Plan Terminations, Liabilities, Settlements and Curtailments," the Paper points out that these types of events are viewed as major and infrequent changes and as extraordinary events that may require special treatment. The Paper includes the statement:

> The termination of a plan, and possibly a major benefit curtailment, is a change in the accounting basis for the cost accrual; that is, the assumption that the plan is an on-going, permanent undertaking has been negated..... such an event is equated to the GAAP concept of an extraordinary event wherein the effect of the event on prior period costs must be fully recognized in the current period.

The Staff Discussion Paper goes on to point out that:

> If a plan is terminated or frozen, then no future or further costs will be computed for that plan against which an amortization installment can be credited. As long as the contractual relationship continues, the amortization installment credits could be reflected in ongoing contract costs and prices. Because there would be no further calculation of costs for that post- retirement benefit plan, a mechanism to effect the adjustment would have to be developed.

This analysis again points out that in the situation in which there is a termination of a contract and/or the related closing of a segment, there is a significant change in circumstance requiring that an accounting practice appropriate for that circumstance be employed.

Topic J - "Adjustments for Segment Closing" of the Staff Discussion Paper specifically notes the types of issues that could arise in this circumstance. Nowhere in this section does the Staff Discussion Paper suggest that there is existing guidance addressing this issue. This again demonstrates that there does not exist any CAS or FAR accounting requirements applicable to TOLIC's situation.

5. Since the FAR Does Not Address Accounting for Post-Retirement Benefits in a Contract Termination Situation, GAAP Principles SFAS 106 and APB Opinion 30 Apply

The FAR does provide guidance for determining the appropriate accounting for those situations in which there is no specific guidance applicable to the costs at issue in either CAS or FAR 31.205. FAR 31.201-2 "Determining allowability" provides that where there is no guidance in the FAR or CAS contractors must look to GAAP and GAAP practices appropriate to the particular circumstances.

As noted above, the applicable GAAP pronouncements are SFAS 106 and APB Opinion 30. SFAS 106 in Paragraph 103 specifies the accounting required for post-retirement benefit costs where there is an abandonment, closure or sale of a segment. It requires that the accounting be accomplished pursuant to the requirements of APB Opinion 30. The recognition of the unfunded liability for the post-retirement benefit plans, a cost in this case, would be included in the gain or loss determined under the requirements of SFAS 106. The requirements of Paragraph 16 of APB Opinion 30 provide that the gain or loss from the disposal of a segment of a business include:

> such adjustments, costs, and expenses which (a) are clearly a direct result of the decision to dispose of the segment and (b) are clearly not the adjustments of carrying amounts or costs for expenses that should have been recognized on a going concern basis after the measurement date....

Clearly, the unfunded liability for TOLIC post-retirement benefit costs is not required to be reported in prior years because of the use of the pay-as-you-go method for government contract accounting. The need to recognize these costs results from the change in circumstance resulting from the termination of the contract and the decision to close the segment. Thus, the need for a change in the appropriate basis of accounting exists. The underlying assumption for amortization of these costs over time is no longer applicable because there will no longer be operation of the plan and/or segment. Thus, under the requirements of Paragraphs 14 and 15 of APB Opinion 30, the recognition of unfunded liabilities for the post-retirement benefit costs resulting in a loss must be recognized in connection with the closing of the segment.

As established in Paragraph 8 of APB Opinion 30, the term "discontinued operations" means "... operations of a segment of a business as defined in Paragraph 13 that has been sold, abandoned, spun-off, or otherwise disposed of, or although still operating is the subject of a formal plan of disposal...." In this case, the requirements of the APB Opinion 30 provide the most appropriate and applicable guidance for the termination of a contract and resulting segment closing, as defined in the CAS requirements.

We note that application of this accounting establishes a direct and equitable counterpart to the requirement of FAR 31.205-6 (o), which requires that the government receive an equitable share of any amount of previously funded post-retirement benefit costs that revert or inure to the contract.

To summarize the position:

1) Neither CAS nor FAR provide specific accounting guidance covering the unfunded liability for post-retirement benefit costs that exist at the time of contract termination and/or segment closing.

2) FAR 31.205-2 provides guidance to contractors and the government to look to the requirements in GAAP in these circumstances.

3) The applicable GAAP in these circumstances are SFAS 106 and APB Opinion 30. The combination of these requirements provides that in the event of a segment closing the net loss -- the unfunded liability for post-retirement benefit costs -- should be recognized as part of the gain or loss on segment closing.

4) The costs to be recognized for the unfunded post-retirement benefit costs are not the costs of any prior cost accounting period. These costs were not required to be recognized under the pay-as-you-go method used to record post-retirement benefit costs for continuing operations. These costs are a direct result of the termination of the contract and the decision to close the segment.

5) These costs are costs of the cost accounting period of the segment closing and are allocable to the work of the TOLIC segment in that cost accounting period.

B. <u>FAR 31.204(c) Also Supports the Conclusion that Unfunded Post-Retirement Benefit Costs Liability Is Properly Recognized in the Cost Accounting Period of the Termination</u>

FAR 31.204(c) notes that the cost principles section, FAR 31.205, does not cover every element of cost, and that the absence of coverage does not imply that the cost is unallowable. Rather that the determination of allowability should be based on "[t]he principles and standards in this subpart and the treatment of similar or related select items."

Under this section, the most relevant similar item would be found in FAR 31.205-6 (j), Pension Costs. Both plans relate to retirement benefits and payments for services rendered in prior and current periods with benefits to be paid out in future periods. FAR 31.205.6 (j) requires that the accounting for these costs be made under the provision of CAS 412 and CAS 413. As a result of applying these criteria, accounting for the unfunded post-retirement benefits liability at the expiration of the contract with the closure of the segment should be governed by the provisions of CAS 413.50-(c)(12) for segment closures.

Accordingly, the same conclusion is reached under FAR 31.204 (c) as under FAR 31.201-2. Under either provision, these costs are costs of the cost accounting period in which the termination of the contract occurred and/or the decision to close the segment was made and are allocable to the work of the TOLIC segment in that cost accounting period.

The OIG notes that "TOLIC has not established a fund or reserve to provide PRBs to retirees." (OIG PRB Rep. at 4.) If, for this reason, the government is unwilling to make payment, TOLIC requests, as an alternative, that HHS enter into an agreement with TOLIC whereby HHS promises to reimburse TOLIC annually for these PRB costs.

C. TOLIC Has Recognized $2,900,000 as the Post-Retirement Benefits Liability Directly Associated with Former Employees of the Medicare Segment

The Financial Accounting Standards Board in SFAS 106 requires companies to accrue the cost of post-retirement benefits over the working lifetimes of employees. Accordingly, TOLIC has recognized this liability in its financial statements. The independent actuarial valuation of FAS 106 liability was $74,735,000 as of December 31, 2000. (Exhibit F, at 6.) The amount directly associated with former employees of TOLIC's Medicare segment was $2,900,000. (See Exhibit B.) None of this expense has been previously paid by HCFA.

III. Conclusion

TOLIC requests that $2,900,000 in PRB costs be included in the termination settlement since the costs are properly accounted for in the cost accounting period of the termination.

::ODMA\PCDOCS\WSH\254883\1

DEPARTMENT OF HEALTH & HUMAN SERVICES

Centers for Medicare & Medicaid Services

Office of the Actuary
7500 Security Blvd, N3-01-21
Baltimore, MD 21244-1850
Phone: 410-786-6383
FAX: 410-786-1295
E-Mail : rsolomon@cms.hhs.gov

MEMORANDUM

To: Greg Tambke, Audit Manager
HHS/OIG/OAS, Jefferson City, Missouri

From: Ron Solomon

Date: March 22, 2002

Subject: Auditee's Response to Draft OIG Audit Report CIN A-07-02-03007, *Post Retirement Benefit Costs Claimed by Transamerica Occidental Life Insurance Company*

In a letter dated February 14, 2002, Transamerica Occidental Life Insurance Company (TOLIC), responding through W. Bruce Shirk of Powell, Goldstein, Frazer and Murphy, LLP, objected to the finding and recommendation in the above cited draft OIG audit report. TOLIC's fundamental argument as to why the Post Retirement Benefit (PRB) accrued liability of $2,900,000[1] should be allowable is that Federal Acquisition Regulation (FAR) 31.205-6(o) only applies to ongoing contract situations, and that in the period of termination the full liability would be recognized in accordance with Generally Accepted Accounting Principles (GAAP)[2]. In its effort to support this position, TOLIC ignores some fundamental requirements of the cost principles (FAR part 31) and quotes portions out of context. The following paragraphs, keyed to the sections in Part II of TOLIC's response, provide details as to why we do not think TOLIC's arguments have merit and thus believe that the claim is unallowable.

A. There is nothing in FAR Part 31 that indicates it only applies to periodic costs. On the contrary, FAR 31.103(b) states, "...the contracting officer shall incorporate the cost principles and procedures in subpart 31.2...in contracts with commercial organizations as the basis for—(1) Determining reimbursable costs under (i) cost reimbursement contracts...performed by commercial organizations." And FAR 31.210-2(d) states "A contractor is responsible for accounting for costs appropriately and for maintaining records...adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart." FAR 31.205-6(o)(2) explicitly gives contractors 3 options for accounting for PRB costs: cash, terminal funding,

[1] Note that in the draft report, the PRB amount recommended for disallowance was $3,060,873. TOLIC asserts in its response that its claim was for $2,900,000. This memo does not address the issue of which amount is correct.
[2] GAAP provisions cited by TOLIC are Statement of Financial Accounting Standard (SFAS) 106 and Accounting Principles Board (APB) Opinion 30.

and accrual. These 3 methods generally differ substantially in the amount of PRB liability recognized in each contract period, and contractors are allowed to choose the method that makes sense for them. TOLIC, having elected cash accounting, now wants to retroactively change methods to what is essentially terminal funding. TOLIC also ignores the fact that there are explicit provisions for contract terminations. FAR 31.103(b) quoted above continues with, "(3) Proposing, negotiating, or determining costs under terminated contracts (see 49.103 and 49.113)." FAR 49.000 "establishes policies and procedures relating to the complete or partial termination of contracts for the convenience of the Government or for default" and is not applicable to TOLIC's non-renewal of its Medicare contract. Given the explicit provisions of the FAR, TOLIC's contention that the Government must look to GAAP for guidance regarding the allowability of this cost is clearly erroneous.

B. TOLIC also attempts to support its arguments by misinterpreting FAR 31.204(c), which states, "Section 31.205 does not cover every element of cost." However, 31.205 clearly and directly covers PRB in 31.205-6(o); it is elements of cost that are not directly covered for which the "determination of allowability shall be based on the principles and standards in this subpart and the treatment of similar or related selected items."

C. Finally, TOLIC suggests that since it is required by SFAS 106 to recognize this PRB liability in its financial statements, it is therefore incumbent upon the Government to reimburse it. TOLIC cites no regulation to support this contention, because of course there is none. Contract costing and financial reporting are not the same; if they were then there would be no need for cost principles and cost accounting standards.

Please feel free to contact me at 410-786-6383 if you have any questions.