Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

SUPPLEMENTAL EMPLOYEE RETIREMENT PLAN COSTS CLAIMED BY TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY

JANET REHNQUIST
INSPECTOR GENERAL

MARCH 2002
A-07-02-03016

Office of Inspector General

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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-07-02-03016
March 27, 2002

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

Dear Mr. Dederer:

This report provides you with the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review titled ***Supplemental Employee Retirement Plan Costs Claimed by Transamerica Occidental Life Insurance Co.*** The purpose of our review was to determine the allowability of $180,244 costs claimed for Medicare reimbursement by Transamerica Occidental Life Insurance Company (TOLIC). The $180,244 represents Supplemental Employee Retirement Plan (SERP) 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 that the SERP costs were unallowable. The TOLIC's response is included in its entirety (less attachments) as Appendix A. Appendix B contains the Centers for Medicare & Medicaid Services (CMS), Office of Actuary's comments on TOLIC's response.

INTRODUCTION

BACKGROUND

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 (CAS), the Federal Acquisition Regulations (FAR) and their Medicare contracts.

TOLIC maintains a SERP, which is a nonqualified plan designed to restore benefits lost under the regular qualified plan due to the Internal Revenue Code 401 (a)(17) and 415 limits. The SERP is a supplemental plan, which in combination with the regular plan provides a single benefit promise to participants. Accordingly, the costs of the SERP should be computed on the same basis as the regular plan.

Prior to March 29, 1988, the accrued costs of a non-qualified pension plan were allocable and allowable only if the benefits provided by the plan were compellable (nonforfeitable) and funded. Otherwise, the allowable cost was limited to the pay-as-you-go cost, that is, actual benefit payments. From March 29, 1988 to the first pension plan year beginning after March 31, 1995, the accrued costs of plans that provide compellable benefits were allocable and allowable whether funded or not.

For the first pension plan year beginning after March 31, 1995, the CAS within 48 CFR 9904.412-50(c)(3) states:

> *The cost of nonqualified defined-benefit pension plans shall be assigned to cost accounting periods in the same manner as qualified plans under the following conditions:*
>
> > *(i) The contractor, in disclosing or establishing his cost accounting practices, elects to have a plan so accounted for;*
> >
> > *(ii) The plan is funded through the use of a funding agency; and,*
> >
> > *(iii) The right to a pension benefit is nonforfeitable and is communicated to the participants.*

The CAS further states that the costs of nonqualified defined-benefit pension plans that do not meet all of the above requirements shall be assigned to cost accounting periods using the pay-as-you-go cost method.

OBJECTIVES, SCOPE AND METHODOLOGY

At the request of the CMS (formerly Health Care Financing Administration), we audited TOLIC's August 1, 2001 claim of $180,244 for SERP 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 SERP 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 (CIN: 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. The information included support provided by TOLIC's consulting actuaries. We examined TOLIC's SERP 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.

FINDING AND RECOMMENDATION

TOLIC claimed $180,244 in SERP costs that they estimate will be incurred after the termination of its Medicare contract. The claim represents a request for reimbursement of unfunded costs. None of these costs is allowable in accordance with the CAS and therefore the costs are unallowable for Medicare reimbursement.

To be allowable for Medicare reimbursement, costs claimed for nonqualified defined-benefit pension plans must be in compliance with CAS 412. The CAS within 48 CFR 9904.412-50(c)(3) states that nonqualified defined-benefit pension plan costs shall be assigned in the same manner as qualified plans if the contractor so elects, if the plan is funded, and if the pension benefits are nonforfeitable. If the nonqualified defined-benefit pension plan does not meet all of these requirements, the costs of the plan shall be assigned using the pay-as-you-go cost method.

TOLIC has not established a fund or reserve to provide a SERP to retirees. Since TOLIC is claiming reimbursement for unfunded costs, the SERP costs must be assigned using the pay-as-you-go cost method. TOLIC has not made any payments for the SERP.

Accordingly, we conclude that the SERP costs of $180,244 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 $180,244 for SERP costs.

Auditee's Comments

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

TOLIC believes that their claim is not governed by the CAS within 48 CFR 9904.412-50(c) since the CAS does not address the accounting for SERP costs in contract termination or segment closing situations. TOLIC also asserts that the need to recognize these unfunded SERP 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 their change in accounting basis.

OIG Response

We disagree with TOLIC regarding the allowability of its SERP 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 on Appendix B.

To be allowable for Medicare reimbursement, costs claimed for nonqualified defined-benefit pension plans must be in compliance with CAS 412. The CAS within 48 CFR 9904.412-50(c)(3) states that nonqualified defined-benefit pension plan costs shall be assigned in the same manner as qualified plans if the contractor has elected to have the plan accounted for, if the plan has been funded, and if the pension benefit is nonforfeitable. If the nonqualified defined-benefit pension plan does not meet all of these requirements, the costs of the plan shall be assigned using the pay-as-you-go cost method. We did not find any provisions in the CAS that indicated it would not apply to contract terminations.

Since TOLIC is claiming reimbursement for unfunded costs, the SERP costs should be assigned using the pay-as-you-go cost method. To date, TOLIC has not made any payments for the SERP. Therefore, the SERP costs of $180,244 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 CMS 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 CMS 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

CMS Action Official:

Ms. Elizabeth Abbott
Regional Administrator, Region IX
Centers for Medicare & Medicaid Services
75 Hawthorne Street, 4th Floor
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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:

Supplemental Retirement Plan Costs Claimed by

Transamerica Occidental Life Insurance Company,

Dated December 2001

W. Bruce Shirk
Mary Baroody Lowe

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Dated: February 14, 2002

EXHIBIT LIST

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

Supplemental Employee Retirement Plan Costs Claimed by
Transamerica Occidental Life Insurance Company,
Dated December 2001

Exhibit A – TOLIC Supplemental Retirement Plan Costs Comparison Chart
Exhibit B – Schedule of Transamerica Supplemental Pension Liability as of 12/31/00
Exhibit C – Transamerica Corporation Supplemental Pension Plan (Jan. 1, 1996)

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

Supplemental Employee Retirement Plan 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-07-02-03016

I. Introduction

Transamerica Occidental Life Insurance Company ("TOLIC") claimed $180,244 in costs that will be paid pursuant to its Supplemental Employee Retirement Plan ("SERP"). The SERP is a "nonqualified plan designed to restore benefits lost under the regular qualified plan due to the Internal Revenue Code 401 (a)(17) and 415 limits." (See Department of Health and Human Services, Office of Inspector General draft report entitled "Supplemental Employee Retirement Plan Costs Claimed by Transamerica Occidental Life Insurance Company," dated December 2001, at 1 (hereafter "OIG SERP Rep."). Although TOLIC has not yet paid the SERP costs claimed, they are known, quantifiable termination costs of a known liability and will be paid. For this reason TOLIC believes the costs are allowable and need to be taken into account as part of TOLIC's contract termination costs. (Exhibit A.)

II. Claimed SERP Costs Should Be Allowed as a Part of the Termination Settlement Because They Are a Known Liability That TOLIC Must Pay

The OIG maintains that $180,244 in SERP costs that will be incurred subsequent to the termination of TOLIC's Medicare contract are unallowable under CAS 412 because the pay-as-you-go method of accounting applies and these costs are unfunded and have not been paid. (OIG SERP Rep. at 3.)

For the reasons set out in the discussion of post-retirement benefit ("PRB") costs in TOLIC's February 14, 2002 Response to the OIG report entitled "Post Retirement Benefit Costs Claimed By Transamerica Occidental Life Insurance Company," dated December 2001, the contract termination creates a change in circumstance such that under the relevant regulations pay-as-you-go accounting is no longer appropriate. The compliant accounting is to recognize the liability as an allowable cost in the cost accounting period of the termination.

The $180,244 claimed represents the accrued liability for payments that must be provided by TOLIC as benefits to four individuals covered by the plan. (Exhibit B.) These SERP costs reflect an unavoidable obligation and will be paid in accordance with the established company policy and plan. (Exhibit C, at Sections 2.23 and 4.1.) They therefore reflect a certain liability that has been incurred by TOLIC for Medicare Division employees. The costs of the SERP benefits are recognized, due to contract termination, in the year of the Medicare Division segment closing.

III. Conclusion

TOLIC requests that $180,244 in SERP costs be included in the termination settlement since the costs reflect an unavoidable liability to be recognized in connection with the termination of the Medicare contract. It would clearly be inequitable for the government to recover a share of excess pension plan assets for Medicare Division employees and refuse, for those same employees, to recognize the costs of their SERP liability.

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DEPARTMENT OF HEALTH & HUMAN SERVICES

Centers for Medicare & Medicaid Services

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MEMORANDUM

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

From: Ron Solomon RS

Date: March 22, 2002

Subject: Auditee's Response to Draft OIG Audit Report CIN A-07-02-03016, *Supplemental Employee Retirement Plan 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 Supplemental Employee Retirement Plan (SERP) accrued liability of $180,244 should be allowable is that this represents a known quantifiable liability that TOLIC must pay, and that in the period of termination the full liability should be reimbursed by the Government. In its effort to support this position, TOLIC ignores some fundamental requirements of the Federal Acquisition Regulation (FAR)—part 31 and the Cost Accounting Standards (CAS)—48CFR 9904.412 & 413. The following paragraphs, keyed to the outline 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.

I. There is nothing in the Government's regulations indicating explicitly or implicitly that this SERP liability is an obligation that the Government should pay, and indeed TOLIC cites no regulatory authority for its position.

II. As in its response to the PRB draft report (CIN A-07-02-03007) TOLIC argues that the contract termination somehow triggers a change in accounting methods. However, 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." CAS 412 explicitly gives contractors 2 options for accounting for nonqualified pension plan costs:

pay-as-you-go (cash) and accrual. These 2 methods generally differ substantially in the amount of SERP liability recognized in each contract period, and contractors are allowed to choose the method that makes sense for them. TOLIC, having elected pay-as-you-go accounting, now wants to retroactively change methods to take advantage of the segment closing provisions of CAS 413.50(c)(12). 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.

III. FAR 31.205-6(j)(2)(i) specifies "For nonqualified pension plans using the pay-as-you-go cost method, to be allowable in the current year, pension costs must be allocable in accordance with 48 CFR 9904.412-50(d)(3)," which states "pension costs assigned to a cost accounting period are allocable in that period." 48 CFR 9904.412-50(b)(3) provides that the assignable cost is the sum of the periodic benefits paid and amortization of lump sum amounts paid. 48 CFR 9904.412-50(c)(3) sets forth the criteria for accounting for SERP costs on the accrual basis. TOLIC elected to not satisfy those criteria and instead chose pay-as-you-go accounting. It cannot now retroactively change methods to the accrual basis so as to take advantage of the segment closing adjustment of 48 CFR 9904.413-50(c)(12), which does apply to its qualified defined benefit pension plan (see draft audit report CIN A-07-01-00125).

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

Appendix C

AUDIT REPORT CIN: A-07-02-03007
TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY

INDIVIDUALS HAVING ACCESS TO SOURCE INFORMATION REGARDING THIS AUDIT REPORT

Greg Tambke, Audit Manager
Scott Englund, Senior Auditor
Dave Imhoff, Auditor
Tricia Hankins, Auditor

Class of Persons Having Access To This Report

Office Administrative Personnel