DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Offices of Audit Services

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

JAN 1 1 2007

Report Number: A-07-05-00189

Ms. Jean Rush, President
CIGNA Government Services
Two Vantage Way
Nashville, Tennessee 37228

Dear Ms. Rush:

Enclosed are two copies of the U.S. Department of Health and Human Services (HHS), Office of Inspector General (OIG) final report entitled "Review of Medicare Contractor's Pension Segmentation Requirements at CIGNA for the Period January 1, 1991, to January 1, 2004." A copy of this report will be forwarded to the HHS action official noted on the following page for review and any action deemed necessary.

The HHS action official will make final determination regarding actions taken on all matters reported. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

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If you have any questions or comments about this report, please do not hesitate to call me at (816) 426-3591, extension 274, or Jenenne Tambke, Audit Manager, at (573) 893-8338, extension 21, or through email at Jenenne.Tambke@oig.hhs.gov. Please refer to report number A-07-05-00189 in all correspondence.

Sincerely yours,

Patrick J. Cogley
Regional Inspector General
for Audit Services

Enclosures

Direct Reply to HHS Action Official:

Mr. Roger Perez
Regional Administrator (Acting), Region 4
Centers for Medicare & Medicaid Services
61 Forsyth Street S.W., Suite 4T20
Atlanta, Georgia 30303-8909

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF MEDICARE CONTRACTOR'S PENSION SEGMENTATION REQUIREMENTS AT CIGNA FOR THE PERIOD JANUARY 1, 1991, TO JANUARY 1, 2004

Daniel R. Levinson
Inspector General

January 2007
A-07-05-00189

Office of Inspector General

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OAS FINDINGS AND OPINIONS

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed, as well as other conclusions and recommendations in this report, represent the findings and opinions of the HHS/OIG/OAS. Authorized officials of the HHS divisions will make final determination on these matters.

EXECUTIVE SUMMARY

BACKGROUND

CIGNA administers Medicare Part B and Durable Medical Equipment operations under cost reimbursement contracts with the Centers for Medicare & Medicaid Services (CMS). CIGNA is a holding company for Connecticut General Life Insurance Company, the legal entity that holds the Medicare contracts. CIGNA HealthCare, one of CIGNA's lines of business, administered the Medicare contracts from March 1990 until May 2005, when CIGNA Government Services was formed and assumed the responsibilities.

Starting with fiscal year 1988, CMS incorporated segmentation requirements into Medicare contracts. The Medicare contract defines a segment and specifies the methodology for the identification and initial allocation of pension assets to the segment. Additionally, the contract requires Medicare segment assets to be updated for each year after the initial allocation in accordance with Cost Accounting Standards 412 and 413.

OBJECTIVES

Our objectives were to determine whether CIGNA complied with the Medicare contracts' pension segmentation requirements while:

- identifying the Medicare segment's initial asset allocation and

- updating the Medicare segment's assets from the initial asset allocation to January 1, 2004.

SUMMARY OF FINDINGS

CIGNA complied with the Medicare contracts' pension segmentation requirements when identifying the Medicare segment's initial assets as of January 1, 1991. However, it did not comply with the contract when updating the segment's assets to January 1, 2004. The understatement primarily resulted from the update of assets and the actuarial approach used in allocating contributions and prepayments to the Medicare segment. As a result, CIGNA understated the January 1, 2004, Medicare segment assets by $99,898.

RECOMMENDATIONS

We recommend that CIGNA:

- increase Medicare segment pension assets by $99,898 as of January 1, 2004, and

- implement controls to ensure that the Medicare segment's assets are updated in accordance with the Medicare contracts.

AUDITEE'S COMMENTS

In its comments on our draft report, CIGNA disagreed in part with our original recommendation to increase Medicare segment assets by $158,339. However, CIGNA ag reed to update future Medicare segment assets in accordance with Medicare contracts.

CIGNA's response is included in its entirety as Appendix B.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

After reviewing CIGNA's comments, we revised our calculations and the related recommendation to increase Medicare segment assets .

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Glossary of Abbreviations and Acronyms

CAS	Cost Accounting Standards
CMS	Centers for Medicare & Medicaid Services
DME	Durable Medical Equipment
ERISA	Employee Retirement Income Security Act
FAR	Federal Acquisition Regulation
GAGAS	generally accepted government auditing standards
OIG	Office of Inspector General
WAV	weighted average value

INTRODUCTION

BACKGROUND

CIGNA and Medicare

On March 1, 1990, CIGNA acquired Equicor, a Medicare contractor and joint venture of the Equitable Life Assurance Society and the Hospital Corporation of America. At that time, the Centers for Medicare & Medicaid Services (CMS) awarded CIGNA cost reimbursement contracts to administer Medicare Part B and Durable Medical Equipment (DME) operations.

CIGNA is a holding company for Connecticut General Life Insurance Company, the legal entity that holds the Medicare contracts. CIGNA HealthCare, one of CIGNA's lines of business, administered the Medicare contracts until May 2005, when CIGNA Government Services, LLC, was formed and assumed the responsibilities.

For the purpose of this report, CIGNA will be used to address the findings concerning the Medicare Part B and DME pension plan segment assets for the period January 1, 1991, to January 1, 2004.

Segmentation Requirements

CMS incorporated segmentation requirements into Medicare contracts starting in fiscal year 1988. The Medicare contract defines a segment and specifies the methodology for the identification and initial allocation of pension assets to the segment. Furthermore, the contract requires Medicare segment assets to be updated for each year after the initial allocation in accordance with Cost Accounting Standards (CAS) 412 and 413. Finally, in claiming costs, contractors must follow cost reimbursement principles contained in the Federal Acquisition Regulation (FAR), CAS, and Medicare contract.

Regulations

The CAS 412 regulates the determination and measurement of pension cost components. It also regulates the assignment of pension costs to appropriate accounting periods.

The CAS 413 regulates the valuation of pension assets, allocation of pension costs to segments of an organization, adjustment of pension costs for actuarial gains and losses, and assignment of gains and losses to cost accounting periods.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

Our objectives were to determine whether CIGNA complied with the Medicare contracts' pension segmentation requirements while:

- identifying the Medicare segment's initial asset allocation and

- updating the Medicare segment's assets from the initial asset allocation to January 1, 2004.

Scope

We reviewed CIGNA's identification of its Medicare segment, computation of the initial assets allocated to the Medicare segment, and update of Medicare assets from January 1, 1991, to January 1, 2004.

Achieving our objectives did not require us to review CIGNA's overall internal control structure. However, we did review controls relating to the identification of the Medicare segment and the update of the segment assets to ensure adherence to the Medi care contract, CAS 412, and CAS 413.

We performed fieldwork at CIGNA's office in Nashville, Tennessee, during June 2005 and February 2006.

Methodology

CIGNA did not maintain records of how it accounted for segment assets when computing pension costs charged to the Medicare contracts. Prior to the Office of Inspector (OIG) review, CIGNA engaged an actuarial consulting firm (Pine Cliff Consulting, Inc.) to analyze and reconstruct its asset accounting. In performing our review, we used the analysis and reconstruction as well as information in the annual actuarial valuations that CIGNA's customary actuarial consulting firm (Prudential Financial) prepared. Th e information included assets, liabilities, normal costs, contributions, benefit payments, investment earnings, and administrative expenses. We reviewed CIGNA's accounting records, pension plan documents, annual actuarial valuation reports, and Department of Labor/Internal Revenue Service Form 5500s. The CMS Office of the Actuary staff used the documents to calculate Medicare segment assets as of January 1, 2004. We reviewed the methodology and calculations.

We performed this review in conjunction with our audit of the pension costs CIGNA claimed for Medicare reimbursement (A-07-06-00209). We used the information obtained and reviewed during that audit in performing this review.

Details of the Medicare segment's updated pension assets from January 1, 1991, to January 1, 2004, are presented as Appendix A.

We performed our review in accordance with generally accepted government auditing standards (GAGAS).

FINDINGS AND RECOMMENDATIONS

CIGNA complied with the Medicare contracts' pension segmentation re quirements in identifying the Medicare segment's initial assets as of January 1, 1991. However, CIGNA did not comply with the pension segmentation requirements while updating the segment's assets to January 1, 2004. In the asset update, CIGNA did not pro perly account for contributions and prepayments, earnings and expenses, and transfers in accordance with the CAS.

As a result, CIGNA understated the January 1, 2004, Medicare segment pension assets by $99,898. The accumulated understatement of Medicare segment assets is shown in Table 1.

Table 1: Summary of Asset Adjustments	
Initial Asset Allocation	$0
Contributions and Prepayment Transfers	(1,327,803)
Earnings and Expenses	874,690
Net Transfers	553,011
(Over)/Understatement	**$99,898**

MEDICARE CONTRACT AND COST ACCOUNTING STANDARDS

Medicare Contract

The Medicare contract identifies a Medicare segment as:

> Any organizational component of the contractor, such as a divisi on, department, or other similar subdivision, having a significant degree of responsibility and accountability for the Medicare contract/agreement, in which:
>
> 1. The majority of the salary dollars is allocated to the Medicare agreement/contract; or,
>
> 2. Less than a majority of the salary dollars is allocated to the Medicare agreement/contract, and these salary dollars represent 40 percent or more of the total salary dollars allocated to the Medicare agreement/contract.

The contract also provides for separate id entification of the pension assets of the Medicare segment. The identification involves the allocation of assets to the Medicare segment as of the first pension plan year after December 31, 1985, in which the salary criterion was met. The allocation is to use the ratio of the actuarial liabilities of the Medicare segment to the actuarial liabilities of the total plan, as of the later of the first day of the first plan year after December 31, 1980, or the first day of the first pension plan year following the date such Medicare segment existed.

Furthermore, the Medicare contract states that: "The pension assets allocated to each Medicare segment shall be adjusted in accordance with CAS 413.50(c)(7)."

Cost Accounting Standards

The CAS 413.50(c)(7) requires that the asset base be adjusted by contributions, permitted unfunded accruals, income, benefit payments, and expenses. For plan years beginning on or before March 30, 1995, the CAS requires investment income and expenses to be allocated among segments in proportion to the beginning of year asset value. For plan years beginning after March 30, 1995, the CAS requires investment income and expenses to be allocated among segments based on the ratio of the segment's weighted average value method (WAV) of assets to total company WAV of assets.

In addition, CAS 413.50(c)(8) requires an adjustment to be made for transfers (participants who enter or leave the segment) if the transfers materially affect the segment's ratio of pension plan assets to actuarial accrued liabilities.

Furthermore, CAS 412.50(a)(4) provides that contributions in excess of the pension cost assigned to the period are recognized as prepayment credits and are accumulated at the assumed valuation interest rate until applied to future period costs. Prepayment credits that have not been applied to fund pension costs are excluded from the value of assets used to compute pension costs.

INITIAL ASSET ALLOCATION

CIGNA complied with the Medicare contract's pension segmentation requirements in identifying the Medicare segment's initial assets as of January 1, 1991.

As described in the Background, CIGNA acquired Equicor on March 1, 1990, and was awarded a new contract to replace Equicor's contract with CMS. CIGNA correctly identified January 1, 1991 (the first day of the first plan year following March 1, 1990) as the date of the initial asset allocation.

The Medicare contract required that the initial allocation of assets to the Medicare segment be determined by multiplying the total plan assets as of January 1, 1991, by a fraction (the "asset fraction"). The fraction's numerator is the actuarial liability for the Medicare segment, and the denominator is the actuarial liability for the total plan. CIGNA determined that the January 1, 1991, actuarial liability for the Medicare segment was zero for asset fraction purposes. Accordingly, CIGNA allocated 0% of the total pension assets to the Medicare segment as of January 1, 1991. We agree with CIGNA's calculations.

COMPONENTS OF ASSET UPDATE

CIGNA did not properly account for contributions and prepayments, earnings and expenses, and transfers in accordance with the CAS while updating the segment's assets to January 1, 2004.

Contributions and Prepayment Transfers Overstated

CIGNA's update methodology did not equitably assign pension contributions to the Medicare segment. As a result, CIGNA overstated contributions and prepayments by $1,327,803.

CIGNA's methodology overstated the contribution and prepayment transfers allocated to the Medicare segment because it included an imputed interest cost to the end of each year and did not reflect the actual timing of funding deposits. In addition, differences in Medicare asset values resulted in differences in the assignable costs that were used to determine contribution and prepayment transfers.

The audited contributions and prepayment transfers are based on the assignable pension costs as calculated by the CMS Office of the Actuary. Since prepayment credits are available at the beginning of the year, they are applied first to cover current year assignable pension costs, and then any remaining prepayment credits are updated with interest to the next measurement (valuation) date. Subsequent contributions are then allocated as needed to assigned pension costs as of the date of deposit.

The contributions and prepayment transfers CIGNA allocated to the Medicare segment were $1,327,803 higher than the audited values, due to differences in assignable pension costs and interest costs.

Earnings and Expenses Understated

CIGNA understated investment earnings, less administrative expenses, by $874,690 for the Medicare segment.

For plan years after March 30, 1995, CIGNA's calculation of the WAV of assets did not properly reflect the timing of contribution deposits and prepayment transfers. CIGNA's calculations assumed that all contributions and prepayment transfers occurred at the end of each year. As a result, its allocation basis was different, which in turn led to incorrect allocation amounts.

Net Transfers Understated

CIGNA made adjustments for transfers in its update of Medicare segment assets from January 1, 1991, to January 1, 2004. However, since complete accrued liability data was unavailable, CIGNA estimated the liabilities for some participant transfers during the period 1992 through 1998. CIGNA used an average accrued liability for all active employees to estimate the transfer liabilities. This approach assumed that the average liability was the same for participants in both the Medicare segment and the rest of the company. However, this assumption is incorrect for transfers out of the Medicare segment because the Medicare segment only dates back to 1991.

We used an average Medicare segment liability to calculate the transfer out liabilities.[1] As a result of the inaccuracies in its approach, CIGNA understated its Medicare segment assets by $553,011.

A comparison of CIGNA's and our calculations of net asset transfers into the Medicare segment is shown in Table 2.

Table 2: Net Asset Transfers			
Year	**OIG**	**CIGNA**	**Difference**
1991	$0	$0	$0
1992	19,198	19,198	0
1993	39,145	(111,762)	150,907
1994	114,125	40,984	73,141
1995	269,682	119,275	150,407
1996	(157,968)	(203,740)	45,772
1997	(117,301)	(242,312)	125,011
1998	(10,051)	(17,824)	7,773
1999	(93,754)	(93,754)	0
2000	(169,829)	(169,829)	0
2001	151,154	151,154	0
2002	40,631	40,631	0
2003	63,820	63,820	0
TOTAL	**$148,852**	**($404,159)**	**$553,011**

UNDERSTATEMENT OF MEDICARE SEGMENT ASSETS

CIGNA did not ensure that the Medicare segment's assets were updated in accordance with the Medicare contract. Thus, it overstated contributions and prepayment transfers by $1, 327,803. At the same time, it understated both earnings and expenses (by $874,690) and net transfers (by $553,011). The combination of these discrepancies results in the fact that as of January 1, 2004, CIGNA understated Medicare segment pension assets by $99,898.

RECOMMENDATIONS

We recommend that CIGNA:

- increase Medicare segment pension assets by $99,898 as of January 1, 2004, and
- implement controls to ensure that the Medicare segment's assets are updated in accordance with the Medicare contracts.

[1]Our calculations incorporate an adjustment for the four individuals (who transferred between pension plan segments) identified by CIGNA in its response to our draft report.

AUDITEE'S COMMENTS

In its comments on our draft report, CIGNA disagreed in part with our original recommendation to increase Medicare segment assets by $158,339. However, CIGNA did agree to update Medicare segment assets in accordance with the Medicare contracts.

In addition to its specific comments, CIGNA questioned whether the structure of the audit as a whole complied with the independence requirements imposed by GAGAS. Specifically, CIGNA stated that we engaged the Office of the Actuary within CMS (a party to the Medicare contracts) to independently calculate CIGNA's pension costs and that we accepted those calculations as correct.

A summary of CIGNA's specific comments follows:

- CIGNA did not agree with our initial asset allocation finding. CIGNA asserted that the initial (January 1, 1991) asset allocation should be zero.

- CIGNA generally concurred with our methodology to determine the amount of assets to be transferred in the cases of pension plan participants who moved between Medicare and Other Segments. However, CIGNA asserted that our computation yielded inappropriate results for four plan participants. For those individuals, CIGNA proposed asset transfer adjustments based on the participant's segment of origin.

- CIGNA did not agree with our calculation of CAS costs when prepayment credits were present.

  - CIGNA asserted that the audit methodology in this respect was a reflected our preference to calculate prepayment credits differently. This "alternative calculation approach," CIGNA said, was inequitable, violated provisions of the revised CAS, and diverged from a prior Government practice.

  - CIGNA disagreed with the audit methodology of applying prepayment credits as of the beginning of the year. CIGNA said that prepayment credits are contractor monies to be applied at the discretion of the contractor and that the CAS permits, but does not require, prepayments to be applied as of the beginning of each plan year to fund current costs.

  - CIGNA questioned the audit approach whereby prepayments were accounted for in the "other" segment until needed to fund future pension costs. CIGNA suggested that this approach contradicted the premise that prepayments are not associated with segments until they are allocated.

- CIGNA questioned the audit approach whereby plan contributions made after the end of the year were deemed to have been made on the last day of the plan year. CIGNA suggested that we arbitrarily applied this Employee Retirement Income Security Act (ERISA) rule to CAS costs.

CIGNA's comments are included in their entirety as Appendix B.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

After reviewing CIGNA's comments, we revised our calculations and the related recommendation to increase Medicare segment assets.

With respect to CIGNA's concerns as to the independence requirements that GAGAS imposes on the audit process, GAGAS allows the use of a specialist (including actuaries) to conduct our audits. We are required to obtain representations from the specialist with regard to the specialist's independence from the activity or program under audit. We received such representations from the CMS Office of the Actuary, Pension Actuarial Staff. Therefore, we believe that we complied with the independence requirements imposed by GAGAS during our review.

With respect to CIGNA's more specific comments:

- We agree with CIGNA that the initial (January 1, 1991) Medicare segment assets should be zero. We have revised our calculations accordingly.

- We agree with CIGNA's approach to making plan adjustments for the four individuals who transferred between segments more than once. We have revised our calculations accordingly.

- We do not agree with CIGNA regarding the determination of pension costs when prepayment credits are present. Provided that current-year pension costs are funded by the tax filing deadline, the source or timing of the funding has –contrary to CIGNA's assertion– no effect on the assignable and allocable pension costs determined under the CAS and is therefore not specifically addressed by the CAS. Instead, the timing of funding deposits affects the interest cost attributable to the delay in funding, which is allowable only in accordance with the FAR.[2] Part 31 of the FAR defines the total cost under a contract as incurred costs and further requires that incurred costs be reasonable to be allowable.[3]

[2]CIGNA effectively acknowledges this fact on page 11 of its response, where it quotes the CAS Board in the Preamble to the Original CAS 412.

[3]The FAR 31.201-2(a) provides that a cost is allowable only when it " . . . complies with the all of the following requirements: (1) Reasonableness, (2) Allocability, and (3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the circumstances." FAR 31.201-3(a) defines a cost to be reasonable if " . . . in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business." Furthermore, FAR 31.201-3(a) provides that "If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable."

This issue of prepayment credits is, as CIGNA correctly states, "quite technical in nature," and the discussion that follows aims to amplify our response to CIGNA's argument. To begin with, our audit methodology reflects the fact that prepayment credits are available to fund the assignable pension cost as of the first day of the year. The contractor has already made the decision to fund these monies into the pension trust, and, for that reason, these monies are currently unavailable to the contractor for any purpose except to liquidate pension costs. It would not be reasonable for a "<u>prudent person in the conduct of competitive business</u>" (emphasis added) to ignore the existence of an available funding credit and thereby incur increased interest costs. Therefore, any increased interest costs resulting from a delay in funding would be unreasonable and unallowable.

Contrary to CIGNA's assertion with respect to the adjustment of CAS pension costs, the preamble to the original CAS 412 does not contemplate the calculation of interest costs based on presumed funding dates. It simply states that the standard does not prohibit an interest adjustment to pension costs from the valuation date to the date of funding. Furthermore, the allowability of interest/investment costs is the purview of the FAR.

Accordingly, the FAR 31.201-1 defines the costs under a contract as ". . . the sum of direct and indirect costs allocable to the contract, incurred or to be incurred . . . ." It goes on to provide that ". . . any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used." This language effectively counters CIGNA's assertion that our approach to the calculation of costs is inequitable. CIGNA's calculation of interest costs includes costs that were not actually incurred. In fact, CIGNA's method of estimating incurred interest costs based on a presumed funding schedule is not equitable because it consistently overstates (maximizes) the interest costs to the Government.

To bolster its arguments as to the validity of its own methods of calculating costs, CIGNA asserted that a senior actuary in the CMS Office of the Actuary, acting in a court case as a Government expert witness, accepted and thereby validated the calculation methodology that CIGNA proposed. This assertion is incorrect. The actuary's comments on the case that CIGNA cited are included in their entirety as Appendix C.

CIGNA also stated that the methodology by which it adjusted contributions to the end of the year was used only to simplify the calculations and did not affect the results. However, CAS 413-50(c)(7) specifies that investment return and expenses are to be allocated among segments based on the weighted average value of assets for each segment. CIGNA's practice of adjusting contributions to the end of the year for purposes of asset rollup and allocation of investment returns does not conform to the weighted average value methodology required by CAS 413-50(c)(7). CIGNA's incorrect allocation of investment income consequently affected the asset values for each segment and the resulting pension costs for all subsequent periods.

In addition, CIGNA's assertion about the accounting of prepayments in the "other" segment misinterpreted the methodology and intent laid out in the applicable CAS. Prepayment credits accounted for within the "other" segment are accumulated with interest at the valuation rate and subtracted from the assets of the "other" segment for purposes of computing audited pension costs, as required under CAS 412-50(a)(4). Prepayment credits are accounted for as part of the "other" segment only for purposes of allocating investment returns and expenses between the segments. This is necessary so that any gain or loss attributable to prepayments (resulting from a difference between the actual investment return and the valuation interest rate) is assigned to the "other" segment. Thus, the inclusion of prepayment credits with the assets of the "other" segment for the purpose of allocating investment returns is consistent with the premise that prepayment credits are the result of the plan sponsor's investment decision to fund amounts in excess of the assigned costs (rather than to retain the funds within the company). As such, the Government should not share in the investment risk/reward associated with those funds.

Finally, CIGNA's statement about the application of the ERISA rule did not take into account the fact that the preamble to the 1995 amendments to CAS 412 and CAS 413 clearly states that the changes were intended to resolve the conflicts between ERISA and the existing CAS. To comply with the intent of the Board and avoid any conflict with ERISA, the ERISA rule regarding interest on contributions made after the end of the year must also be applied for CAS purposes.

OTHER MATTER

In the proposed asset update, CIGNA's practice was to allocate funding to the Medicare segment first and then to allocate remaining funding to the non-Medicare segment. The CAS 413-50(c)(1)(ii) states that: ". . . for qualified defined-benefit pension plans, the contractor may first apportion amounts funded to the segment or segments subject to this Standard." However, because CIGNA charges pension costs for both the Medicare and the non-Medicare segments, this sentence from CAS 413-50(c)(1)(ii) does not apply. Therefore, funding must be allocated proportionately to the pension costs assigned to both segments. While there was no cost effect during this audit period, future allocations and asset updates could be misstated, unless funding is allocated proportionately to both the Medicare and the non-Medicare segments.

APPENDIXES

CIGNA
Statement of Medicare Pension Assets
For the Period
January 1, 1991, to January 1, 2004

Description		Total Company	Other Segment	Medicare Segment
Assets January 1, 1991	1/	$1,228,189,751	$1,228,189,751	$0
Prepayment Transfer		0	0	0
Contributions	2/	59,398,839	58,889,116	509,723
Other Transactions	3/	392,613	392,613	0
Earnings	4/	232,068,030	232,068,030	0
Benefit Payments	5/	(66,067,157)	(66,067,157)	0
Expenses	6/	(1,154,689)	(1,154,689)	0
Transfers	7/	0	0	0
Assets January 1, 1992		1,452,827,387	1,452,317,664	509,723
Prepayment Transfer	8/	0	(239,833)	239,833
Contributions		65,766,989	65,469,420	297,569
Other Transactions		(315,077)	(315,077)	0
Earnings		50,248,816	50,222,891	25,925
Benefit Payments		(74,236,487)	(74,235,968)	(519)
Expenses		(2,178,499)	(2,177,375)	(1,124)
Transfers		0	(19,198)	19,198
Assets January 1, 1993		1,492,113,129	1,491,022,524	1,090,605
Prepayment Transfer		0	(317,300)	317,300
Contributions		72,864,403	72,609,685	254,718
Other Transactions		0	0	0
Earnings		178,479,268	178,310,861	168,407
Benefit Payments		(82,874,619)	(82,869,663)	(4,956)
Expenses		(2,892,086)	(2,889,357)	(2,729)
Transfers		0	(39,145)	39,145
Assets January 1, 1994		1,657,690,095	1,655,827,605	1,862,490
Prepayment Transfer		0	(540,722)	540,722
Contributions		69,542,458	69,407,189	135,269
Other Transactions		0	0	0
Earnings		44,938,395	44,873,246	65,149
Benefit Payments		(88,979,990)	(88,976,747)	(3,243)
Expenses		(5,341,698)	(5,333,954)	(7,744)
Transfers		0	(114,125)	114,125
Assets January 1, 1995		$1,677,849,260	$1,675,142,492	$2,706,768

CIGNA
Statement of Medicare Pension Assets
For the Period
January 1, 1991, to January 1, 2004

Description	Total Company	Other Segment	Medicare Segment
Assets January 1, 1995	$1,677,849,260	$1,675,142,492	$2,706,768
Prepayment Transfer	0	(815,546)	815,546
Contributions	70,187,350	70,187,350	0
Other Transactions	3,105	3,105	0
Earnings	361,069,805	360,311,810	757,995
Benefit Payments	(99,178,621)	(99,145,345)	(33,276)
Expenses	(3,543,292)	(3,535,854)	(7,438)
Transfers	0	(269,682)	269,682
Assets January 1, 1996	2,006,387,607	2,001,878,330	4,509,277
Prepayment Transfer	0	(822,866)	822,866
Contributions	15,880,466	15,880,466	0
Other Transactions	244,080	244,080	0
Earnings	266,534,270	265,811,472	722,798
Benefit Payments	(108,857,838)	(108,780,348)	(77,490)
Expenses	(6,506,923)	(6,489,277)	(17,646)
Transfers	0	157,968	(157,968)
Assets January 1, 1997	2,173,681,662	2,167,879,825	5,801,837
Prepayment Transfer	0	(621,510)	621,510
Contributions	57,651,414	57,634,961	16,453
Other Transactions	61,684	61,684	0
Earnings	372,680,499	371,559,562	1,120,937
Benefit Payments	(110,738,168)	(110,634,267)	(103,901)
Expenses	(3,160,735)	(3,151,228)	(9,507)
Transfers	0	117,301	(117,301)
Assets January 1, 1998	2,490,176,356	2,482,846,328	7,330,028
Prepayment Transfer	0	0	0
Contributions	0	0	0
Other Transactions	16,582	16,582	0
Earnings	343,998,996	342,977,970	1,021,026
Benefit Payments	(125,614,758)	(125,364,081)	(250,677)
Expenses	(5,853,314)	(5,835,941)	(17,373)
Transfers	0	10,051	(10,051)
Assets January 1, 1999	$2,702,723,862	$2,694,650,909	$8,072,953

CIGNA
Statement of Medicare Pension Assets
For the Period
January 1, 1991, to January 1, 2004

Description	Total Company	Other Segment	Medicare Segment
Assets January 1, 1999	$2,702,723,862	$2,694,650,909	$8,072,953
Prepayment Transfer	0	(772,020)	772,020
Contributions	0	0	0
Other Transactions	67,086,949	67,086,949	0
Earnings	659,789,825	657,592,080	2,197,745
Benefit Payments	(156,905,299)	(156,698,126)	(207,173)
Expenses	(4,199,989)	(4,185,999)	(13,990)
Transfers	0	93,754	(93,754)
Assets January 1, 2000	3,268,495,348	3,257,767,547	10,727,801
Prepayment Transfer	0	(831,790)	831,790
Contributions	0	0	0
Other Transactions	0	0	0
Earnings	(225,585,090)	(224,778,803)	(806,287)
Benefit Payments	(173,195,470)	(172,821,783)	(373,687)
Expenses	(6,702,661)	(6,678,704)	(23,957)
Transfers	0	169,829	(169,829)
Assets January 1, 2001	2,863,012,127	2,852,826,296	10,185,831
Prepayment Transfer	0	(930,610)	930,610
Contributions	0	0	0
Other Transactions	4,415	4,415	0
Earnings	(209,307,282)	(208,479,723)	(827,559)
Benefit Payments	(164,071,126)	(163,829,083)	(242,043)
Expenses	(10,638,255)	(10,596,193)	(42,062)
Transfers	0	(151,154)	151,154
Assets January 1, 2002	2,478,999,879	2,468,843,948	10,155,931
Prepayment Transfer	0	(133,854)	133,854
Contributions	42,190,106	42,190,106	0
Other Transactions	0	0	0
Earnings	(267,528,935)	(266,398,113)	(1,130,822)
Benefit Payments	(178,975,677)	(178,596,640)	(379,037)
Expenses	(15,800,073)	(15,733,287)	(66,786)
Transfers	0	(40,631)	40,631
Assets January 1, 2003	$2,058,885,300	$2,050,131,529	$8,753,771

CIGNA
Statement of Medicare Pension Assets
For the Period
January 1, 1991, to January 1, 2004

Description		Total Company	Other Segment	Medicare Segment
Assets January 1, 2003		$2,058,885,300	$2,050,131,529	$8,753,771
Prepayment Transfer		0	(559,863)	559,863
Contributions		116,200,000	116,054,011	145,989
Other Transactions		0	0	0
Earnings		482,163,037	479,947,631	2,215,406
Benefit Payments		(204,340,355)	(203,789,258)	(551,097)
Expenses		(26,919,762)	(26,796,073)	(123,689)
Transfers		0	(63,820)	63,820
Assets January 1, 2004		$2,425,988,220	$2,414,924,157	$11,064,063
Per CIGNA	9/	$2,425,988,220	$2,415,024,055	$10,964,165
Asset Variance	10	$0	($99,898)	$99,898

FOOTNOTES

1/ We agreed with Cigna's determination of the Medicare segment's initial assets. The amounts shown for the Other segment represent the difference between the total company and the Medicare segment. All pension assets are shown at market value.

2/ We obtained total company contribution amounts from the actuarial valuation reports and Department of Labor/Internal Revenue Service Form 5500s. We allocated total company contributions to the Medicare segment based on the ratio of the Medicare segment funding target divided by the total company funding target. Contributions in excess of the funding targets were treated as prepayment credits and accounted for in the Other segment until needed to fund pension cost in the future.

3/ We obtained other transactions from documents prepared by CIGNA's consulting actuarial firm. Other transactions represent plan merger and asset transfer activities.

4/ We obtained investment earnings from actuarial valuation reports and documents prepared by CIGNA's consulting actuarial firm. We allocated investment earnings based on the market value of Medicare assets at the beginning of the plan year after adjustment for transfers. For years starting with 1996, we allocated investment earnings based on the ratio of the segment's Weighted Average Value (WAV) of assets to total company WAV of assets as required by the Cost Accounting Standards.

5/ We reviewed and accepted CIGNA's benefit payments to Medicare segment retirees.

6/ We allocated administrative expenses to the Medicare segment in proportion to investment income.

CIGNA
Statement of Medicare Pension Assets
For the Period
January 1, 1991, to January 1, 2004

7/ CIGNA made adjustments for participant transfers between segments. We accepted CIGNA's calculations except as explained in the Components of Asset Update section.

8/ Prepayment credits represent funds available to satisfy future funding requirements, and are applied to future funding requirements before current year contributions in order to reduce interest costs to the Federal Government. Prepayment credits are transferred to the Medicare segment as needed to cover funding requirements.

9/ We obtained total asset amounts as of January 1, 2004, from documents prepared by CIGNA's actuarial consulting firm.

10/ The asset variance represents the difference between our calculation of Medicare segment assets and CIGNA's market value of assets.

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July 14, 2006

Mr. Patrick J. Cogley
Regional Inspector General for Audit Services
Department of Health & Human Services
601 East 12th Street
Room 284A
Kansas City, MO 64106

Re: Draft Audit Reports A-07-05-00189 and A-07-06-00209

Dear Mr. Cogley:

CIGNA Government Services ("CIGNA") appreciates this opportunity to submit comments on two draft audit reports related to the CIGNA Pension Plan ("Plan"). These draft audit reports, "Review of Medicare Contractor's Pension Segmentation Requirements at CIGNA for the Period January 1, 1991, to January 1, 2004," which is numbered A-07-05-00189 (the "Asset Report") and "Review of Pension Costs Claimed for Medicare Reimbursement by CIGNA for Fiscal Years 1991 through 2004," which is numbered A-07-06-00209 (the "Cost Report"), pertain to submissions made to the Centers for Medicaid and Medicare Services ("CMS") dated December 9, 2004 ("Initial Submission") and May 27, 2005 ("Supplemental Submission"; collectively the "Submissions"). Because the issues raised in the Asset Report and the Cost Report (collectively, the "Draft Reports") are interrelated, this letter offers our comments in consolidated form.

As explained in the body of this letter, CIGNA concurs with the recommendations made by the Office of the Inspector General ("OIG") in some respects but does not concur in other respects, as set forth below:

1. ***Indirect pension costs***. CIGNA concurs with the amount of indirect pension costs that were actually allocated to the Medicare contracts between January 1, 1991 and September 30, 2004, as previously discussed with the OIG. Likewise, CIGNA concurs with the percentages of Other segment pension costs that are allocable to the Medicare program, as also previously discussed with the OIG. However, the proper amount of Other segment pension costs for the January 1, 1991 to September 30, 2004 period remains unresolved pending resolution of the remaining open issues that are addressed in this letter.

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2. ***Transfer methodology***. CIGNA concurs generally with the methodology proposed by the OIG to determine the amount of assets to be transferred on account of Plan participants who moved between the Medicare and Other segments. As explained below, however, it is CIGNA's view that the OIG's proposal yields inappropriate results for four Plan participants.

3. ***Pension cost controls***. Page i of the Asset Report expresses the OIG's recommendation that CIGNA "implement controls to ensure that the Medicare segment's assets are updated in accordance with the Medicare contracts"; similarly, page i of the Cost Report recommends that CIGNA "claim future pension costs in accordance with the Medicare contracts." CIGNA concurs, and intends to implement these recommendations in accordance with the process changes recommended by Pine Cliff Consulting in Section VII of the Initial Submission.

CIGNA notes that most of the dollar difference between CIGNA's position (as set forth in the Submissions) and OIG's position (as set forth in the Draft Reports) are associated with the first two issues identified above (i.e., indirect pension costs and participant transfers between segments), and that CIGNA concurs generally with the OIG's position on these matters. The rest of this letter explains CIGNA's areas of concern and nonconcurrence with other findings in the Draft Reports.

OIG Audit Approach

It appears that the OIG focused its analysis upon Cost Accounting Standards ("CAS") 412 and 413 pension cost calculations that were made by the CMS Office of the Actuary rather than the corresponding calculations that were contained in the Submissions. For example, the OIG states, on page 5 of the Asset Report:

> The audited contributions and prepayment transfers <u>are based on the assignable pension costs as calculated by the CMS Office of the Actuary</u>. ...

Emphasis added. As we understand it, the CMS actuaries utilized a portion of the data contained in the Submissions to independently calculate CIGNA's CAS pension costs, compared the results of its calculations with the amounts submitted on FACPs by CIGNA, and deemed any differences to be unallowable.1 However, the fact that a variance existed between calculations performed by

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[1] See page 3 of the Cost Report. The "Per OIG" column apparently refers to calculations of CAS pension costs made by the CMS Office of the Actuary, and the "Per CIGNA" column represents amounts which have subsequently been deemed by CIGNA and OIG to have been reported on CIGNA's FACPs or otherwise charged to CMS over the years. Hence, the amounts of CAS pension costs included in the Submissions were not factored into the OIG's determination of the "$3,425,240 of unallowable pension costs" discussed on page 3 of the Cost Report.

a CMS actuary versus those performed by a CIGNA actuary does not mean that the amount of variance represents an unallowable cost.[2] Although the specific issues identified in the Draft Reports account for a portion of the OIG's proposed determination of unallowable costs, additional – and as yet unidentified – factors may also account for the remainder of the alleged unallowable costs.

We further note the CMS actuaries' work product was commissioned by and was provided to the OIG; stated differently, the OIG was the client of the CMS Office of the Actuary for purposes of making those pension cost calculations (even though, in the larger sense, CMS is essentially OIG's client). If our understanding is correct, it is not clear how this process complied with the "independence" requirements imposed by generally accepted Government auditing standards.[3] Specifically, Section 3.04 of the Government Audit Standards states:

> Auditors and audit organizations have a responsibility to maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as impartial by knowledgeable third parties. Auditors should avoid situations that could lead reasonable third parties with knowledge of the relevant facts and circumstances to conclude that the auditors are not able to maintain independence and, thus, are not capable of exercising objective and impartial judgment on all issues associated with conducting and reporting on the work.

In this case, the OIG is charged with auditing pension costs submitted by CIGNA to CMS. However, it appears that OIG engaged CMS – a party to the Medicare contracts – to independently calculate CIGNA's pension costs, and that the OIG then accepted as correct the results of the CMS calculations.

In any event, CIGNA respectfully requests that the OIG identify the specific CAS provisions that it believes CIGNA violated in the pension cost calculations contained in the Submissions. Further, it is CIGNA's position that the calculations made by its actuaries should form the basis for the settlement of pension costs for the period through 2004 as well as for future periods.

With that background, the remainder of this letter addresses three areas where the substantive differences identified in the Draft Reports have not yet been resolved: (1) the initial asset allocation; (2) the treatment of four participants who transferred between the Medicare and Other

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[2] It is well established within the actuarial profession that, although calculations made by two actuaries may yield different results, it does not necessarily follow that one of the two actuaries has erred. Rather, the difference may be attributable to the use of different, but nonetheless acceptable, actuarial techniques.

[3] Government auditing standards are published by the General Accountability Office; see http://www.gao.gov/govaud/yb/2003/html/TOC.html.

segments; and (3) the proper manner to determine CAS pension costs in the presence of prepayment credits.

Initial Asset Allocation

As explained on page III-10 of the Initial Submission, CIGNA did not allocate any pension assets to the Medicare segment as of January 1, 1991 (the "Allocation Date"). In the Asset Report, the OIG contends that CIGNA's treatment violated contractual requirements.4

For a number of reasons, CIGNA does not concur with this aspect of the OIG's recommendations. First, it is undisputed that the former Equicor employees who comprised the workforce of the Medicare segment as of the Allocation Date were not covered by the Plan until the Allocation Date; for this reason, it is clear that no pension costs were allocated to the Medicare program prior to the Allocation Date. Because all assets that had accumulated in the Plan as of the Allocation Date were attributable to contributions made on behalf of CIGNA's non-Government businesses, logic dictates that CMS is not entitled to benefit from those assets. From a contractual perspective, it is CIGNA's position that the initial asset allocation is properly computed to be zero, which is consistent with an actuarial liability of zero as of the Allocation Date prior to giving effect to the Plan amendment that extended coverage to the former Equicor employees (this position is discussed below in more depth).

Second, the intent of allocating assets to a segment under the original version of CAS ("Old CAS"5) 413 is quite clear: to track the assets accumulated on behalf of that segment. For example, when the necessary data are "readily determinable," Old CAS 413.50(c)(5)(i) requires the assets of a segment to equal:

> ... the amount of funds contributed by, or on behalf of, the segment, increased by income received on such funds, and decreased by benefits and expenses paid from such funds;

In this situation, "the amount of funds contributed by, or on behalf of, the segment," the "income received on such funds" and the "benefits and expenses paid from such funds" are each clearly zero. On this basis, Old CAS 413 requires the use of this "readily determinable" data to yield zero pension assets for the Medicare segment as of the Allocation Date; any other result would violate CAS 413.50(c)(5)(i).

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[4] The OIG apparently does not contend that CIGNA's initial allocation of assets to the Medicare segment violated CAS requirements.

[5] Revised versions of CAS 412 and 413 ("New CAS") were published in the Federal Register on March 30, 1995 and were effective for CIGNA on January 1, 1996.

Third, and notwithstanding the facts in this situation, suppose that the data needed to apply Old CAS 413.50(c)(5)(i) were not "readily determinable," thereby requiring application of Old CAS 413.50(c)(5)(ii). In this case, assets would have been allocated "in a manner consistent with the actuarial cost method or methods used to compute pension cost." Thus, because an asset allocation must be made pursuant to Old CAS 413.50(c)(5)(ii) in a manner consistent with past pension costs,6 and because there were no past pension costs, the amount of assets allocated under Old CAS 413.50(c)(5)(ii) must necessarily equal zero. Similar to the conclusion in the preceding paragraph, any other result would violate Old CAS 413.50(c)(5)(ii).

The Asset Report states that "CIGNA did not comply with the Medicare contract's pension segmentation requirements"7 because no assets were allocated to the Medicare segment as of the Allocation Date. In essence, the OIG urges a mechanical application of the contract without considering whether its interpretation appropriately applies the provision in question. The following points analyze this issue in more depth:

- ***Purpose: assets attributable to costs prior to Allocation Date.*** The standard contractual language in question (which was included at Tab L of CIGNA's Initial Submission) was clearly intended to apply to contractors that had charged pension costs to the Medicare program prior to the effective date of Old CAS 412 and 413. To illustrate, paragraph A. of the pension section of the Medicare contract discusses the treatment of pension costs allocated to prior Medicare contracts, even though no such costs existed for CIGNA.

- ***Interpret vs. override.*** Section I.C. of Appendix B to CIGNA's Medicare contracts states that CAS 412 and 413 "shall apply" in "computing and allocating pension costs to" the contract. Paragraph A. of Section XVI. of Appendix B states that "CAS 413 shall be interpreted and applied as specified herein." It is thus clear that the Medicare contract seeks to interpret rather than to override CAS 413; in this manner, the contractual language should not be read in a manner inconsistent with a plain reading of CAS 413. As explained earlier, no assets would be allocated to the Medicare segment pursuant to either Old CAS 413.50(c)(5)(i) or (ii); the same answer must be obtained under the contractual language.

- ***Actuarial liability.*** As explained in footnote 17 on page III-10 of CIGNA's Initial Submission, CIGNA viewed the Medicare segment actuarial liabilities of $156,606 as the effect of a current

[6] We conclude that only past pension costs are considered in an Old CAS 413.50(c)(5)(ii) calculation for two reasons. First, the term "used" is in the past tense. Second, it is obvious that assets must be allocated to a segment prior to the initial determination of pension costs on a segmented basis; as a matter of logic, if there have been no past pension costs, there would likewise be no basis upon which to allocate assets, further supporting CIGNA's position that no assets are properly allocable to the Medicare segment as of the Allocation Date.

[7] See Asset Report, page 4.

year event (i.e., the January 1, 1991 plan amendment) as opposed to obligations attributable to prior years. Old CAS 413.30(a)(4) defines "actuarial liability" to be:

> Pension cost attributable, under the actuarial cost method in use, to years prior to the date of a particular actuarial valuation.
>
> In practice, no pension costs were attributable to periods prior to January 1, 1991; as such, the proper measure of actuarial liability as of January 1, 1991 is zero. In contrast to the interpretation urged by the OIG, CIGNA's interpretation – that the appropriate actuarial liability for this purpose is the liability prior to the effect of the Plan amendment – harmonizes the requirements of the Medicare contract with the provisions of Old CAS 413.50(c)(5).

Transfers between Medicare and Other Segments

In the Submissions, CIGNA estimated the actuarial liability for transferred employees as the average liability for all active members of the Plan. On page 6 of the Asset Report, the OIG notes that this approach could yield biased results because members of the Medicare segment did not earn pension benefits for periods prior to 1991 while members of the Other segment were credited with pension benefits in all prior years.

CIGNA concurs generally with the logic posited by the OIG and, with one exception pertaining to four Plan participants8 who transferred between segments more than once, is prepared to accept the OIG's position regarding employee transfers.

CIGNA's sole area of nonconcurrence is limited to individuals who transferred both in and out of a segment during the period in question. In such cases, CIGNA believes that the OIG's recommendation would itself introduce an unwarranted (and likely inadvertent) bias; to address this concern, CIGNA proposes that transfer amounts for such individuals be based upon the participants' segment of origin. Thus, the average liability for active Plan participants would be used when a Participant first transfers from the Other segment to the Medicare segment and also when that same participant later returns to the Other segment. Similarly, the average liability of the active Medicare segment participants would be used for participants who first transfer from the Medicare segment to the Other segment and then later return to the Medicare segment.

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[8] For privacy purposes, the four individuals in question are not identified in this letter; CIGNA will provide this information to the OIG under separate cover.

Calculation of CAS Pension Costs when Prepayments are Present

The final open issue is quite technical in nature, and concerns the proper manner of determining CAS pension cost when "prepayment credits" are available to fund pension costs. On page 5 of the Asset Report, the OIG states that:

> ... Since prepayment credits are available at the beginning of the year, they are applied first to cover current year assignable pension costs, and any remaining prepayment credits are updated with interest to the next measurement (valuation) date. ...

Before delving into the analysis, it is helpful to first review the nature of "prepayment credits" as well as the manner in which CAS pension costs are adjusted from the first day of a plan year to the presumed date(s) of funding:

- ***Prepayment credits.*** New CAS 412-30(a)(23) defines "prepayment credits" as follows:[9]

  > Prepayment credit means the amount funded in excess of the pension cost assigned to a cost accounting period that is carried forward for future recognition. ...

  Emphasis in original. Thus, prepayment credits arise when a contractor makes pension contributions that exceed the amount of its CAS pension costs.

- ***Adjustment of CAS pension cost to presumed funding date(s).*** Because actuarial valuations are typically made on the first day of a plan year, but contributions are generally made at one or more later dates, pension costs are typically adjusted with interest at the valuation rate from the valuation date to the date(s) of payment; in this manner, the pension fund is compensated for the investment income that would presumably have been earned if the funding had occurred on the valuation date. The original CAS Board specifically sanctioned this approach:

  > Several commentators stated that they compute pension cost at the beginning of a cost accounting period and add interest at the valuation rate to the normal cost to the date of funding. ... The Standard being promulgated does not prohibit this practice ...

  In practice, contractors typically compute CAS pension costs based upon assumed funding dates. For at least the last 20 or so years, the Government was aware of and incorporated this practice into its standard pension review policies:

  > The amount of interest added in the actuarial valuation to the amount of pension cost due as of the valuation date should be reviewed. The amount of add on interest included in charges to Government contracts should not exceed (8.5

9 Although Old CAS 412 did not define the term "prepayment credits," the substantive requirements of both Old CAS 412 and New CAS 412 are identical. See Old CAS 412.50(a)(7).

> divided by 12) X (the actuarial interest rate) X (the contribution due as of the beginning of the valuation period).10

Emphasis added. It is important to note that, in practice, the interest calculations are documented in the actuarial valuation report. In other words, the interest adjustment is made on the basis of assumed contribution dates rather than at a later date based upon the *actual funding dates.*

With that background, we now address a key issue raised in the Asset Report. In essence, the OIG contends that, when prepayment credits are present, CAS pension costs must be calculated based upon presumed funding on the first day of the plan year. To illustrate, suppose the pension cost for a year is measured to be $1,000 as of the first day of the year, that pension costs are presumed to be funded in accordance with the FAR schedule, and that the valuation interest rate is 8.50%. In the absence of prepayment credits, all parties would agree that the CAS pension cost for the year, adjusted for interest, would be determined as follows:11

$$\text{CAS Pension Cost} \quad = \$1{,}000 \times \left(1 + \frac{8.5}{12} \times 8.50\%\right)$$
$$= \$1{,}060$$

The CAS cost calculations in the Submissions were made in a manner consistent with the $1,060 for all years. In contrast, the OIG contends that the CAS cost would be limited to $1,000 if prepayment credits of at least $1,000 were present at the beginning of the Plan year. For the reasons set forth below, the OIG's position is incorrect:

- ***Absence of noncompliance.*** Although the Asset Report contends that the Submissions did not properly calculate the amount of CAS pension costs, the OIG has not explained how CIGNA's calculation violated any provisions of CAS 412, CAS 413 or the FAR. To the contrary, the OIG seems only to assert that it would have made the calculations differently. It is CIGNA's position that, pursuant to its contract, it is entitled to recover its pension costs that are (1) measured, assigned and allocated in accordance with CAS 412 and 413 and (2) allowable under the FAR, notwithstanding the OIG's preference for an alternative calculation approach.

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10 See Defense Contract Administration Services Manual for Conducting Contractor Insurance/Pension Reviews, June 1987, page 32. The factor of "8.5 divided by 12" is equivalent to the funding schedule set forth at Federal Acquisition Regulation ("FAR") § 31.205-6(j)(2)(iii), which contemplates that pension costs be funded 30 days after the end of each quarter.

11 This approach is consistent with both CIGNA's approach in the Submissions as well as the calculations made by the CMS actuaries; see, e.g., the "Allowable Interest" calculation for 1991 of $27,855 as reported on page1 of the appendix to the Cost Report.

- ***Inconsistent with prior Government position***. The position taken in the Asset Report – that there is but one correct method to calculate costs when prepayment credits are present – is inconsistent with the position taken by the Government in the Kodak litigation.[12] As background, Kodak had a prepayment credit of approximately $242.4 million at the end of 1982.[13] Although Kodak's pension plan was not fully funded in 1982, it became fully funded by January 1, 1984 due to stock market gains and other factors.[14] The fundamental issue in Kodak concerned the proper interpretation of CAS 412: notwithstanding the fully funded status of the plan, Kodak contended that pension costs were properly assignable to 1984 through 1986 pursuant to CAS 412; in contrast, the Government asserted that no pension costs were assignable.

  Kodak's consulting actuary, John B. McQuade (who also serves as an actuarial consultant to CIGNA) calculated the amount of Kodak's pension cost for the 1984 to 1986 period.[15] The following table illustrates the elements of Kodak's 1984 "Pension Costs Under CAS 412 (thousands of dollars)" as reported in the Stipulation:[16]

Normal Cost	101,372
Amortization payments	(11,559)
Interest on normal cost and amortization	5,726
Total measured cost	95,539

  The stipulated interest calculation of $5,726 was made using the same formula described above:

$$\text{CAS Pension Cost Interest} = \text{Beginning of Year Cost} \times \left(\frac{8.5}{12} \times \text{Interest rate}\right)$$
$$= (\$101{,}372 - 11{,}559) \times \left(\frac{8.5}{12} \times 9.00\%\right)$$
$$= \$5{,}726$$

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[12] See Appeal of Eastman Kodak Company Under Contract No. F33657-79-C-0127, Armed Services Board of Contract Appeals ("ASBCA") No. 51326.

[13] See Joint Stipulation of Facts in Kodak ("Stipulation"), paragraph 27.

[14] Id, paragraph 30.

[15] Id, paragraph 32.

[16] Id.

Although the Government disputed Kodak's interpretation of CAS 412, it agreed that the calculations made by Mr. McQuade were correct:

> ... The parties stipulate that Mr. McQuade's calculations are mathematically correct and represent an accurate actuarial calculation of total measured pension cost, if any allocable pension cost is deemed to be incurred during the period at issue. ...17

Eric Shipley, a senior CMS actuary, served as an expert witness for the Government in Kodak. In his deposition, Mr. Shipley indicated that he and Mr. McQuade were "in accord" with each other aside from the fundamental legal issue that was in dispute:

> Q Do you have any significant disagreement with Mr. McQuade about – putting aside the question of whether there is [sic] costs for CAS purposes, do you have any serious disagreement with him about the way he's calculated the pension costs for Kodak?
>
> A I after I got his report, I took his report and my report ... and I did a reconciliation ... And John and I, other than our interpretation differences, I believe are in accord with each other.18

In the hearing at the ASBCA on July 27, 2000, Mr. Shipley reiterated his view that, aside from the fundamental issue of interpretation under CAS 412, Mr. McQuade's calculations were correct. Specifically, Mr. Shipley stated that, when comparing his calculations with those performed by Mr. McQuade, "[t]here were some minor, immaterial differences in our computations, and I'm going to accept ... his computations."19 Mr. Shipley further stated that he had "done a reconciliation of John's numbers to mine, and, you know, all the variances are understandable."20

Thus, in litigation involving CAS pension costs of $189.5 million,21 the Government and Mr. Shipley accepted the exact same calculation methodology proposed by CIGNA, further underscoring the fact that there simply is no basis for the OIG to question this aspect of CIGNA's Submissions.

- ***OIG's approach is inequitable***. If CIGNA had not made pension contributions in excess of its CAS pension costs, the OIG would have accepted CAS pension costs including interest to

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17 Id, paragraph 33.

18 See Deposition of Eric H. Shipley in Kodak, May 9, 2000, pages 15-16.

19 See Transcript of Kodak hearing, July 27, 2000, page 53.

20 Id, page 56.

21 See Kodak Stipulation, paragraph 32. The sum of CAS 412 "[p]ension costs assigned to Kodak divisions" for 1984 through 1986 equals $189,524,000. Note that this represents the total CAS pension cost for all of Kodak.

the quarterly funding dates.22 Thus, under the approach urged by the OIG, the amount of CIGNA's allowable pension costs will be reduced solely on account of CIGNA's decision to make pension contributions that exceeded its CAS pension costs. Such a result is wrong for several reasons:

⇒ ***Government policy encourages earlier pension funding***. It is well accepted that Government contracting policy favors earlier rather than later pension funding. Indeed, Government pension specialists devote considerable resources to identifying and disallowing pension costs that were made too late. Under the position taken by the OIG, however, the Government would be in the curious position of penalizing contractors that fund early as well as those that fund late!

⇒ ***Prepayments belong to a contractor and do not impact CAS costs.*** It is well accepted that prepayment credits belong to contractors. For example, a handout prepared by the panelists (which included Eric Shipley of CMS) at a session of the 2006 Enrolled Actuaries' Meeting titled "Consulting with Government Contractors" states that "[p]repayments and deposits to the fund are contractor monies ..." It simply does not make sense that the Government can reap a benefit from an asset in which it has no interest.

Consider a situation where a contractor is considering when to fund its pension costs. The original CAS Board viewed this as an "investment decision" of the contractor:

> ... the Board believes that interest cost resulting from the delayed funding of a pension plan is a consequence of an investment decision and is, therefore, an investment cost rather than a component of pension cost. The interest was caused by a decision of management to use its funds for other purposes; in effect, management borrowed from the pension trust fund.[23]

In other words, a contractor that funds late has made a judgment that retaining cash within the company (as opposed to making a pension contribution) will optimize its financial results. In such a case, the CAS Board indicated that the Government must not be penalized for any increased pension costs that result from the delay in pension funding. It seems obvious that the converse should also apply -- the Government has no entitlement to participate in the reduced pension costs that result from a plan sponsor's "investment decision" to fund pension costs early. Yet, the approach urged by the OIG would lead to such a result.

To ensure that the Government does not participate in the effect of contractors' prefunding "investment decisions," CAS 412 provides that pension costs are to be determined as if the contractor had not made any contributions in excess of its CAS

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[22] As noted earlier, this statement is supported by the 1991 "allowable interest" calculation of $27,855 for the Medicare segment as reported on page 1 of the appendix to the Cost Report.

[23] See Prefatory Comment (10) to Old CAS 412.

pension costs. For example, prepayment credits must be excluded from the asset values that are used to compute pension costs pursuant to New CAS 412-50(a)(4):

> ... The accumulated value of any prepayment credits shall be excluded from the actuarial value of the assets used to compute pension costs for purposes of this Standard and Cost Accounting Standard 9904.413.

In similar fashion, New CAS 412 ensures that the Government does not participate in increased pension costs that arise due to late pension funding; see New CAS 412-50(a)(2).

⇒ ***Similarly-situated contractors would receive different treatment.*** Consider two contractors that are identically situated except that one contractor prefunds its pension costs and the other does not. In this situation, if the position asserted by the OIG is correct, the Government would enjoy lower pension costs on the work performed by the prefunding contractor vis-à-vis the second contractor even though the workforces, benefits, levels of CAS assets[24] and CAS costs measured as of the first day of the plan year would all be identical. Such a result is inequitable, is contrary to fundamental Government contracting objectives and supports CIGNA's contention that the OIG's position is incorrect.

⇒ ***The OIG's approach yields an interest-free loan.*** Utilizing the numerical example described earlier, the OIG asserts that CIGNA should be reimbursed at $1,000 rather than at $1,060 when prepayments of at least $1,000 are present. The OIG adopted this approach "in order to reduce interest costs to the Federal Government."[25] The OIG apparently seeks to implement this financially oriented goal (which should also be reviewed in the context of the "independence" requirements described earlier) by attempting to force CIGNA to provide an interest-free loan to the Government.

To illustrate by building upon the example described above, the OIG contemplates that the allowable pension cost for the year would be $1,000, which would be considered to be liquidated on the first day of the plan year. The $1,000 would be treated as an allocable cost under the terms of the Medicare contract and hence would be recovered by CIGNA through progress payments on a monthly basis throughout the year in question. In essence, this would mean that CIGNA would fund pension costs of $1,000 at the beginning of the year and would then recover the $1,000 throughout the year; on balance the Government would receive an interest-free loan of $1,000 for approximately half a year. Such a result is clearly inequitable.

- ***The Government's approach violates New CAS 412-60(c)(5).*** As explained above, prepayments are unquestionably a corporate asset. Nonetheless, the Asset Report asserts that the Government has the right to direct the manner in which this "corporate asset" is deployed:

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[24] See the discussion of New CAS 412-50(a)(4) in the preceding paragraph.

[25] See footnote 8 on page 5 of the Appendix to the Asset Report.

> Since prepayment credits are available at the beginning of the year, they are applied first to cover current year assignable pension costs, and any remaining prepayment credits are updated with interest to the next measurement (valuation) date.[26]

Notwithstanding, New CAS 412-60(c)(5) clarifies that the contractor (and not the Government) has discretion with respect to the application of prepayment credits and, in any event, demonstrates conclusively that the position articulated in the Asset Report is wrong.

As background, the illustration at New CAS 412-60(c)(5) contemplates a situation where the CAS 412 assignable pension cost is $1.5 million, the contribution amount is $1.0 million and prepayment credits at the beginning of the period are $700,000. The following points analyze how New CAS 412-60(c)(5) and related provisions apply to CIGNA:

⇒ ***Application of prepayment credits is discretionary***. New CAS 412-60(c)(5) states that the contractor "can" apply prepayment credits towards pension costs; it does not say that the contractor "shall" or "must" apply prepayment credits. Accordingly, it is CIGNA's view that prepayments are to be applied at the discretion of the contractor. This conclusion is supported further by two additional illustrations in New CAS 412, as discussed below.

New CAS 412-60(c)(13) deals with a situation where a contractor contributes $100,000 more than the assignable pension cost while having an unfunded liability under CAS 412-50(a)(2) of $75,000. In this case, the CAS Board stated that the contractor:

> … <u>may</u> use $75,000 of the contribution … to fund this separately identified unfunded actuarial liability, <u>if he so chooses</u>. … [The contractor] shall then account for the remaining $25,000 of excess contribution as a prepayment credit …

Emphases added. Clearly, the CAS Board intended the contractor to retain control over the manner in which prepayment credits are applied. In addition, New CAS 412-60(d)(4) states that "[t]he accumulated value of prepayment credits … <u>may</u> be used to fund the next year's assigned pension cost, if needed" (emphasis added). In summary, there is ample evidence that the CAS Board intended to provide contractors with the discretion to apply their prepayment credits in the manner and at the time they deemed appropriate.

⇒ ***Amount of prepayment to be applied is discretionary***. The Asset Report, as cited earlier, is based upon the premise that the full amount of any prepayment credits that exist at the beginning of a plan year must be applied towards that year's CAS pension cost. However, this position is in direct conflict with the illustration at New CAS 412-60(c)(5).

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[26] See Asset Report, page 5.

Under the theory articulated in the Asset Report, the hypothetical contractor described at New CAS 412-60(c)(5) would have been required to apply the full $700,000 of prepayments towards the $1.5 million cost for the year. However, New CAS 412-60(c)(5) provides that the contractor "can apply $500,000 of the accumulated value of prepayment credits towards the pension cost computed for the period." At the same time, it seems obvious that the contractor could, if it so chose, reduce its cash funding and hence utilize the full $700,000 of available prepayment credits.

In summary, the contractor described in CAS 412-60(c)(5) can choose to apply its prepayment credits before or after it applies its contributions, at its discretion. The OIG is incorrect when it asserts that it can direct CIGNA to apply the full amount of its prepayment credit to fund CAS pension costs on the first day of the plan year.

⇒ ***CAS cost is unaffected by the amount of applied prepayment***. The OIG believes that the amount of "allocable" CAS pension cost for a period is a function of the relative amounts of prepayment credits and contributions that are applied to liquidate the costs assigned to the period. To illustrate, the OIG essentially splits the beginning-of-year CAS pension cost into two elements: (1) the portion funded by prepayment credits and (2) the portion funded through contributions. The OIG then asserts that the portion of the CAS pension cost funded through prepayments cannot adjusted for interest. The OIG does, however, include an interest adjustment on the portion of the CAS cost funded through current year contributions. In our view, there are at least four problems with this aspect of the OIG's methodology.

First, the regulations offer no support for the proposition that the OIG's approach is mandatory.[27] Second, the OIG's approach would be highly impractical in practice; that is because, in some contractual settings, CAS pension costs must be known before a contractor could reasonably elect the portion of its pension costs to be funded from prepayments vs. current contributions. Third, the OIG's approach would provide a contractor with the ability to direct, on an after-the-fact basis,[28] the amount of its CAS pension costs, which would be inconsistent with the "anti-gaming" objective of the CAS.

The fourth problem is that the OIG calculates "allocable pension cost" as a function of "allowable interest." In fact, however, the pension cost process is sequential: pension costs are first measured, assigned and allocated pursuant to CAS 412 and are then tested for allowability under the FAR. Hence, the OIG's approach would impermissibly mix the "measurement, assignment and allocation" requirements of the CAS with the "allowability" requirements of the FAR.

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27 Similarly, CIGNA acknowledges that the regulations do not prohibit this aspect of the OIG's approach. However, to disallow pension costs, the OIG bears the burden of proving that CIGNA's approach does not comply with CAS requirements.

28 Specifically, a contractor would have until the tax filing date for the year in question to determine the mix of contributions and prepayment credits to be applied to fund its pension costs for the year. Under the OIG's approach, CAS costs could not be finalized until the contractor made such an election.

Other Matters

On page 5 of the Asset Report, the OIG expresses its understanding that CIGNA "included an imputed interest cost to the end of each year and did not reflect the actual timing of funding deposits." It appears that the OIG misunderstood these aspects of CIGNA's calculation methodology. For example, see pages IV-4 through IV-8 and V-10 through V-11 of the Initial Submission for a description of how Pine Cliff Consulting utilized "end of year" amounts to simplify certain aspects of the calculations without affecting the results (which are based on the FAR quarterly funding schedule). In addition, the "actual timing of funding deposits" was taken into account in the Submissions; see, for example, the interest calculations on pages S8 and S9 of the spreadsheets in the Initial Submission.[29]

On page 4 of the appendix to the Asset Report, the OIG states that prepayment credits were "accounted for in the other segment until needed to fund pension cost in the future." In CIGNA's view, this treatment is incorrect. We further observe that this approach appears to contradict information presented by panelists (including Eric Shipley of CMS) at the Government contractor session of the 2006 Enrolled Actuaries Meeting: "prepayments ... are not associated with segments ... until they are allocated to segments ..."

CIGNA's Revised Position

As explained above, CIGNA does not concur with the OIG's recommendations with respect to the initial asset allocation and the determination of pension costs when prepayment credits are present, and partially concurs with respect to transfers. On these bases, CIGNA has recalculated the amount of cost and asset value adjustments versus those reported in the Submissions; the results of these calculations, which represent CIGNA's revised position on these questions, are reported on the attached exhibits. It is CIGNA's view that its revised positions address the legitimate concerns expressed in the Draft Reports and comply fully with CAS 412, CAS 413, the FAR and CIGNA's Medicare contracts.

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[29] We further note that, in footnote 3 on page 8 of the Appendix to the Cost Report, the OIG states that it "deemed deposits made after the end of the plan year to have been made on the final day of the plan year." CIGNA does not understand why this ERISA rule would be arbitrarily applied to CAS costs, especially in light of the prohibition against increased costs resulting from late contributions at FAR 31.205-6(j)(2)(iii) and the OIG's expressed concern regarding the utilization of more precise funding dates.

CIGNA appreciates the opportunity to submit these comments and looks forward to working with you and your colleagues to reach a mutually satisfactory conclusion of the pension audit process. Any questions or concerns should be directed to Jeff Chambers of CIGNA Government Services at (615) 782-4676.

Sincerely,

Jean Rush

cc: Jeff Chambers, CGS
Mike Logan, CGS
Lori Borelli, CMS

Attachments

CIGNA Government Services
Audit Response
Exhibit 1

	Assets as of January 1, 2004 per CIGNA Response to Draft Audit Report	Assets as of January 1, 2004 per Draft Audit Report	Difference
Medicare	10,941,673	11,122,504	(180,831)
Other	2,321,230,784	2,414,865,716	(93,634,932)
Prepayments	93,815,763	0	93,815,763
Total	2,425,988,220	2,425,988,220	0

CIGNA Government Services
Audit Response
Exhibit 2

Year	Pension Cost Actually Charged to CMS	Pension Costs Determined per CIGNA Response to Draft Audit Report	Difference
1991	468,067	421,690	46,377
1992	498,965	619,677	(120,712)
1993	715,988	660,021	55,967
1994	770,621	766,101	4,520
1995	770,454	914,085	(143,631)
1996	778,545	942,848	(164,303)
1997	706,543	800,530	(93,987)
1998	713,529	188,538	524,991
1999	936,756	597,501	339,255
2000	875,348	817,554	57,794
2001	1,405,331	903,264	502,067
2002	1,111,214	370,772	740,442
2003	1,266,228	672,261	593,967
2004	1,277,413	937,718	339,695
Total	12,295,002	9,612,560	2,682,442

DEPARTMENT OF HEALTH & HUMAN SERVICES

Centers for Medicare & Medicaid Services

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MEMORANDUM

To: Jenenne Tambke, Audit Manager, HHS OIG OAS

From: Eric H. Shipley, Senior Pension Actuary

Date: September 22, 2006

Subject: CIGNA's Response Citing Testimony in Eastman Kodak (ASBCA No. 51326)

In its response to draft audit reports A-07-05-00189 and A-07-06-00209, CIGNA infers that I approved or agreed with Mr. McQuade's position that quarterly interest is an inherent component of pension cost, regardless of whether the interest was actually incurred. An examination of the complete record shows that I clearly espoused a different position on this detail of the computation, which was not the primary issue before the Armed Services Board of Contract Appeals in Eastman Kodak Company (ASBCA No. 51326, July 24, 2001). The issue before the ASBCA was whether there was any pension cost to be liquidated when the pension plan was in a surplus position.

In Appendix II of my Expert Witness Report, April 10, 2000, I clearly applied the prepayment to the pension cost to be liquidated as of the first day of the plan year, and did not allow any interest in the computation of the allowable pension cost.

I had previously provided to the Government attorneys a reconciliation of the pension cost computations done by Mr. Lussier, Kodak's actuary, Mr. McQuade, Kodak's expert witness, and myself. In footnote 1 of that reconciliation, I explained that "[b]ecause the Prepayment is available on January 1, the full pension cost is funded as of January 1 and no interest is accrued on the pension cost." There were many computational differences between the three of us, but the significant differences arose from whether there was or was not an pension cost to be liquidated when the pension plan was in a surplus position, which was the issue being litigated.

During my deposition on May 9, 2000, I was asked: "Do you have any significant disagreement with Mr. McQuade about – putting aside the question of whether there is costs for CAS purposes, do you have any serious disagreements with him about the way he's calculated the pension costs for Kodak?" To which I answered: "After I got his report, I took his report and my report, and in fact, I looked at every calculation that Mr. Lussier had done and I did a reconciliation of all three – columns and numbers. And John and I, ***other than our***

interpretation differences, I believe are in accord with each other." [***Emphasis added.***] There were many differences between the details of the computations made by Kodak's actuary, Mr. McQuade and myself, which were not addressed in the complaint and litigation.

Before considering if the surplus liquidated the pension cost, the pension costs computed by Mr. Lussier and myself were within 5% of the pension costs computed by Mr. McQuade for the period 1983 to 1986. Therefore, for purposes of narrowing the issues to be heard by the ASBCA, the attorneys for the Government and Kodak agreed to accept Mr. Quade's computations as representing the pension costs for the period presuming that there was a pension cost to be liquidated. My expert witness report, which was predicated on the surplus liquidating the pension cost, explicitly excluded imputed interest on the prepayment credit.

It is noteworthy that the ASBCA found for the Government and the U.S. Court of Appeals affirmed the decision for the Government (Case No 02-1058, January 16, 2003).