DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date SEP 30 1993

From Bryan B. Mitchell
Principal Deputy Inspector General

Subject Review of Unfunded Pension Costs of the Travelers Insurance Company (A-07-93-00665)

To Bruce C. Vladeck
Administrator
Health Care Financing Administration

This is to alert you to the issuance on October 6, 1993, of our final audit report. A copy is attached. Our review showed that as of January 1, 1991, Travelers Insurance Company (Travelers) had accumulated $1.2 million in pension costs that are unallowable for Medicare reimbursement.

For Medicare reimbursement, pension costs must be (1) measured, assigned, and allocated in accordance with Cost Accounting Standards (CAS) 412 and 413; and (2) funded as specified by part 31 of the Federal Acquisition Regulations (FAR). Pension costs assigned to an accounting period, but not funded by tax filing deadlines, may not be reassigned to or claimed in subsequent accounting periods. Also, interest on any unfunded costs is an unallowable component of pension costs of future cost accounting periods.

The FAR funding requirement has traditionally been satisfied by trust fund deposits qualifying for tax exemptions under the Employee Retirement Income Security Act of 1974 (ERISA). The ERISA provides for a minimum and a maximum deposit to pension funds as determined each year. The minimum represents a required deposit while the maximum represents the upper limit that can be deducted for income tax purposes for the year for which the deposit is applicable.

Pension costs computed in accordance with CAS represent an assignment of pension costs to specific accounting periods. Historically, CAS pension costs often fell between ERISA minimum and maximum contributions. In addition, before 1986, if CAS pension costs were greater than maximum ERISA contributions, contractors could deposit the CAS amounts in qualified trust funds, claim them as allowable contract costs, and take ERISA maximums as tax deductions. The excess of the CAS amount over the ERISA maximum could be carried forward to future years for tax deductibility. Similarly, if contractors deposited ERISA maximums that were larger than CAS computed amounts, differences could be carried forward as allowable contract costs for future years.

The Tax Reform Act of 1986 (TRA '86) changed the effect of making pension plan contributions in excess of ERISA maximums. The ERISA maximum was still the tax deductible limit and the excess could still be carried forward to future years for deductibility. However, TRA '86 imposed an excise tax of 10 percent on contributions in excess of ERISA maximums. The excise tax is cumulative from year to year.

With the Omnibus Budget Reconciliation Act of 1987 (OBRA '87), the Congress took additional action affecting contractors' pension plan contributions. The OBRA '87 imposed a second more restrictive test to the full funding limitation. The more restrictive test caused most pension plans that were already in full funding to retain their full funding status longer and pushed additional plans into a full funding status.

Travelers made contributions to the pension trust fund from 1986 through 1990. However, during this period, Travelers did not fully fund the pension costs identifiable with its Medicare segment. By not fully funding pension costs, Travelers lost allowability of the costs under Medicare. Considering unallowable interest on the deposits not made, Travelers has accumulated $1.2 million as of January 1, 1991 that must be separately identified and excluded as future components of Medicare pension costs.

We are recommending that Travelers: (1) separately identify $1.2 million as an unallowable component of pension costs as of 1991, (2) continue a yearly update of unallowable pension cost components related to the unfunded CAS costs for 1986 through 1990, and (3) identify unallowable components of pension costs for any subsequent years for which CAS costs of the pension plan are not funded.

Travelers disagreed with the calculations in the report and expressed its intent to seek a waiver which would allow Travelers to reassign and claim any unfunded costs in future accounting periods. Regional Health Care Financing Administration officials agreed with our findings and recommendations.

Attachment

For further information contact:
Vincent R. Imbriani
Regional Inspector General
for Audit Services, Region VII
(816) 426-3591

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF UNFUNDED PENSION COSTS OF THE TRAVELERS INSURANCE COMPANY

SEPTEMBER 1993 A-07-93-00665

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-07-93-00665

Mr. Richard S. Stuart
Second Vice President
The Travelers Insurance Company
Medicare Administration
2 Riverview Square
East Hartford, Connecticut 06118

Dear Mr. Stuart:

This report provides you with the results of our "REVIEW OF UNFUNDED PENSION COSTS OF THE TRAVELERS INSURANCE COMPANY" as of January 1, 1991. The purpose of our review was to determine unfunded pension costs for Calendar Years 1986 through 1990 and the resulting accumulated unfunded pension costs as of January 1, 1991.

As of 1991, The Travelers Insurance Company (Travelers) had accumulated $1.2 million in pension costs which are unallowable for Medicare reimbursement. Pension costs assigned to an accounting period, but not funded by the tax filing deadlines, may not be reassigned to or claimed in subsequent accounting periods. Also, no amount for interest on the portion not funded in a period can be a component of pension costs of any future cost accounting period.

Travelers made contributions to the pension trust fund from 1986 through 1990. However, during this period, Travelers did not fully fund the pension costs identifiable with its Medicare segment. As a result, Travelers accumulated unfunded pension costs of $1.2 million as of January 1, 1991. Travelers must separately identify and eliminate this amount from the amortization components of future pension costs. Travelers did not agree with our recommendations. Travelers' comments are included in their entirety as Appendix B.

BACKGROUND

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

The FAR funding requirement has traditionally been satisfied by trust fund deposits qualifying for tax-exemptions under the Employee Retirement Income Security Act of 1974 (ERISA). The ERISA provided for a minimum and a maximum deposit to pension funds as determined each year. The minimum represented a required deposit while the maximum represented the upper limit that could be deducted for income tax purposes for the year for which the deposit was applicable.

Pension costs computed in accordance with CAS represented an assignment of pension costs to specific accounting periods. The CAS pension costs often fell between ERISA minimum and maximum contributions. In addition, before 1986, if CAS pension costs were greater than maximum ERISA contributions, contractors could deposit the CAS amounts in qualified trust funds, claim them as allowable contract costs, and take ERISA maximums as tax deductions. The excess of the CAS amount over the ERISA maximum could be carried-forward to future years for tax deductibility. Similarly, if contractors deposited ERISA maximums that were larger than CAS computed amounts, differences could be carried forward to fund allowable contract costs for future years.

The Tax Reform Act of 1986 (TRA '86) changed the effect of making pension plan contributions in excess of ERISA maximums. The ERISA maximum was still the tax deductible limit and the excess could still be carried forward to future years for deductibility. However, TRA '86 imposed an excise tax of 10 percent on contributions in excess of ERISA maximums. The excise tax is cumulative from year to year and applied on a first-in/first-out basis considering carry-forwards and current year contributions.

With the Omnibus Budget Reconciliation Act of 1987 (OBRA '87), the Congress took additional action affecting contractors' pension plan contributions to qualified trust funds. Prior to OBRA '87, ERISA's full funding limitation traditionally considered accumulated assets and the actuarial liability. If assets equalled or exceeded actuarial liability, then the tax-deductible amount was limited to zero.

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

SCOPE OF AUDIT

We made our examination in accordance with generally accepted government auditing standards. This audit addresses only one expense category, pension costs. Our objective was to identify unfunded CAS costs, plus appreciation on the unfunded costs, for January 1, 1986 through December 31, 1990. Achieving our objective did not require that we review the internal control structure of Travelers.

This review was done in conjunction with our segmentation audit of Travelers (A-07-93-00634). The information obtained and reviewed during the audit of segmentation costs was also used in performing this review.

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

Field work was performed during June 1992 at Travelers' corporate offices in Hartford, Connecticut.

RESULTS OF AUDIT

We found that, as of January 1, 1991, Travelers had accumulated $1,218,963 in unallowable direct pension costs related to its Medicare segment. The pension costs are unallowable because they were not funded within specific time periods set by regulation. Imputed interest on the unfunded costs is also unallowable. The $1,218,963 represents unfunded pension costs and imputed interest involving 1986 through 1990. In addition, Travelers cannot claim any of these unfunded costs in future cost accounting periods.

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

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

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

Furthermore, the CAS within 48 CFR 30.412-50(a)(7)[1] states:

> "If any portion of the pension costs computed for a cost accounting period is not funded in that period, no amount

[1] Recodified at 48 CFR 9904.412-50(a)(7), effective date April 17, 1992.

for interest on the portion not funded in that period shall be a component of pension cost of any future cost accounting period."

In addition, the CAS within 48 CFR 30.412-50(a)(2)[2] states:

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

We compared CAS pension costs for the Medicare segment, computed by HCFA Office of the Actuary, to Travelers' actual contributions to the Medicare segment and found the following. Appendix A provides additional information.

	1/1/86	1/1/87	1/1/88	1/1/89	1/1/90
CAS Pension Costs	$801,364	$800,469	$1,057,129	$1,045,953	$1,229,895
Interest to End of Year	68,116	68,040	89,856	88,906	104,542
Less:					
Prepayment Credit	-0-	-0-	151,185	322,675	504,913
Interest to End of Year	-0-	-0-	12,850	27,427	42,917
Actual Contribution	475,966	979,679	1,273,095	1,280,098	72,215
Interest to End of Year	25,389	40,015	32,529	9,572	5,598
Under (Over) funding	$368,125	$(151,185)	$ (322,674)	$ (504,913)	$ 708,794

For 1986 and 1990, Travelers had not funded, in full, the CAS pension costs within the required time periods; therefore, the pension costs are unallowable as a component of pension costs for any future years. Interest related to these unfunded costs is also unallowable as a component of future years' pension costs.

The following table shows the unfunded amounts plus interest which are unallowable on a cumulative basis. Our computation of the unfunded amounts considered those costs which should have been funded for the applicable years. In other words, if Travelers funded the costs, the assets of the Medicare segment would have been greater at the specified time periods.

Unfunded Pension Costs and Interest

Date	1986	1987	1988	1989	1990	Total
1/1/87	$368,125	$ -0-	$ -0-	$ -0-	$ -0-	$368,125
1/1/88	399,416	(151,185)	-0-	-0-	-0-	248,231
1/1/89	433,366	-0-	(322,674)	-0-	-0-	110,692
1/1/90	470,202	-0-	-0-	(504,913)	-0-	(34,711)
1/1/91	510,169	-0-	-0-	-0-	708,794	1,218,963

[2] Recodified at 48 CFR 9904.412-50(a)(2), effective date April 17, 1992.

Recommendations

We recommend that Travelers:

- o Identify $1,218,963 as an unallowable component of direct pension costs as of 1991.
- o Update annually the unallowable pension cost component related to the unfunded CAS costs for 1986 through 1990.
- o Identify and track unfunded pension costs occurring in later years.

AUDITEE COMMENTS

"The Travelers cannot agree to such recommendation, for the reasons set forth below."

"The report does not provide an explanation with respect to the January 1, 1986 commencement date of the OIG's examination of The Travelers' unfunded pension costs."

"For instance, insofar as the Report addresses only pension costs, specifically unfunded pension costs, a reasonable start date for the OIG review is the point in time the pension funding requirement as reflected in section 48 CFR 31.205-6(j)(3)(i) of the FAR became a part of the underlying contracts. It is indisputable that the funding requirement set forth in the underlying contracts and FAR existed before 1986, thus supporting an earlier commencement date for the OIG's Report. Moreover, a review of the underlying contracts, FAR and CAS do not give any indication that 1986 is the required start date of the OIG review of The Travelers' pension costs."

"...it is The Travelers intent to make a formal request for a waiver from the cost assignment provision of CAS 412.40(c) and FAR 31.30.412.40(c), with respect to any underfundings that may ultimately be appropriately calculated."

OIG RESPONSE

CAS Cost Computation Starting Date

Medicare contractors should have computed a CAS cost starting October 1, 1980, the date on which the CAS first became applicable to the Medicare contracts. In most instances, contractors, including Travelers, never made such calculations. In response to our 1985 audit report concerning the pension issue, HCFA and Medicare contractors agreed to a specific method for establishing an asset base for the segment as of 1986.

The contract's specific method requires that Medicare contractors make the initial asset allocation as of the first day of the first pension plan year following December 31, 1985. Under the contract, if contractors comply with the terms of the agreement the initial asset allocation as of 1986 would account for all plan and segment activity.

Therefore, we purposely chose the 1986 starting date for computing CAS costs to coincide with the contract required asset allocation date. Given the agreement between HCFA and the contractors, we believe that it was appropriate to compute the CAS cost starting with the allocation date. We have consistently used the same CAS computation starting date for all Medicare contractors.

Waiver Request

The Travelers indicated that it intends to request a waiver from the provisions of CAS 412.40(c), which prohibits the reassignment of pension costs to future periods. We do not have the authority to grant a waiver.

The CAS Board delegated waiver authority only to agencies' senior procurement executives; it cannot be redelegated. Travelers needs to contact HCFA about the procedures to be followed if it wishes to pursue the granting of a waiver.

If such a wavier is granted for prior years, it would not apply to CAS 30.412.50(a)(7), which states that "no amount for interest on the portion not funded in that period shall be a component of pension cost of any future cost accounting period."

Our position on interest agrees with the following part of a May 27, 1992 memorandum from the Office of the Undersecretary of Defense titled "Waiver of Cost Accounting Standard (CAS) 412.40(c)." Guidelines attached to the memorandum state that, in determining reassignable amounts of pension costs, "additional interest incurred on the unfunded liability, as a result of delayed funding, is unallowable."

INSTRUCTIONS FOR AUDITEE RESPONSE

Final determinations as to actions taken on all matters reported will be made by the Department of Health and Human Services (HHS) action official named on the following page. We request that you respond to the HHS action official within 30 days from the date of this report. Your response should present any comments or additional information that you believe may have a final bearing on the final determination.

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

If you have any questions or wish to discuss the report in further detail, please contact Mr. Jim Aasmundstad, Audit Manager, at (816) 426-3591. Please refer to the Common Identification Number in all correspondence about this report.

Sincerely,

John J. Gradzicki
for Vincent R. Imbriani
Regional Inspector General
for Audit Services, Region VII

Appendices

Direct Reply to HHS Action Official:

Mr. Sidney Kaplan
Regional Administrator, Region I
Health Care Financing Administration
John F. Kennedy Federal Building
Room 2325
Boston, Massachusetts 02203

TRAVELERS INSURANCE COMPANY
HARTFORD, CONNECTICUT

STATEMENT OF CAS PENSION COSTS AND FUNDING

FOR THE PERIOD
JANUARY 1, 1986 TO JANUARY 1, 1991

			Total Plan	Other Segment	Medicare Segment
01/01/86	Amortization Payment	1/	$ 13,691,710	-	-
	EAN Normal Cost	2/	26,133,441	-	-
01/01/86	CAS Pension Cost	3/	39,825,151	$ 39,023,787	$ 801,364
	Interest to 12/31/86	4/	3,385,138	3,317,022	68,116
12/31/86	CAS Funding Target	5/	43,210,289	42,340,809	869,480
	Contribution	6/	23,653,951	23,177,985	475,966
	Interest on Contribution	7/	1,261,747	1,236,358	25,389
12/31/86	**Unfunded Pension Cost**	8/	**$ 18,294,591**	**$ 17,926,466**	**$ 368,125**
01/01/87	Amortization Payment		$ 9,355,558	-	-
	EAN Normal Cost		28,861,401	-	-
01/01/87	CAS Pension Cost		38,216,959	37,416,490	800,469
	Interest to 12/31/87		3,248,441	3,180,401	68,040
12/31/87	CAS Funding Target		41,465,400	40,596,891	868,509
	Contribution		46,773,010	45,793,331	979,679
	Interest on Contribution		1,910,452	1,870,437	40,015
12/31/87	**Unfunded Pension Cost**		**$ (7,218,062)**	**$ (7,066,877)**	**$ (151,185)**
01/01/88	Amortization Payment		$ 8,136,755	$ 7,803,146	$ 333,609
	EAN Normal Cost		33,532,445	32,808,925	723,520
01/01/88	CAS Pension Cost		41,669,200	40,612,071	1,057,129
	Interest to 12/31/88		3,541,882	3,452,026	89,856
12/31/88	CAS Funding Target		45,211,082	44,064,097	1,146,985
	Contribution		50,181,990	48,908,895	1,273,095
	Interest on Contribution		1,282,214	1,249,685	32,529
	Prepayment Credit	9/	7,218,062	7,066,877	151,185
	Interest on Prepayment	10/	613,535	600,685	12,850
12/31/88	**Unfunded Pension Cost**		**$(14,084,719)**	**$(13,762,045)**	**$ (322,674)**

TRAVELERS INSURANCE COMPANY
HARTFORD, CONNECTICUT

STATEMENT OF CAS PENSION COSTS AND FUNDING

FOR THE PERIOD
JANUARY 1, 1986 TO JANUARY 1, 1991

		Total Plan	Other Segment	Medicare Segment
01/01/89	Amortization Payment	$ 3,019,050	$ 2,728,407	$ 290,643
	EAN Normal Cost	34,321,686	33,566,376	755,310
01/01/89	CAS Pension Cost	37,340,736	36,294,783	1,045,953
	Interest to 12/31/89	3,173,963	3,085,057	88,906
12/31/89	CAS Funding Target	40,514,699	39,379,840	1,134,859
	Contribution	45,699,773	44,419,675	1,280,098
	Interest on Contribution	341,738	332,166	9,572
	Prepayment Credit	14,084,719	13,762,044	322,675
	Interest on Prepayment	1,197,201	1,169,774	27,427
12/31/89	**Unfunded Pension Cost**	**$(20,808,732)**	**$(20,303,819)**	**$ (504,913)**
01/01/90	Amortization Payment	$(15,576,552)	$(15,929,453)	$ 352,901
	EAN Normal Cost	35,115,029	34,238,035	876,994
01/01/90	CAS Pension Cost	19,538,477	18,308,582	1,229,895
	Interest to 12/31/90	1,660,771	1,556,229	104,542
12/31/90	CAS Funding Target	21,199,248	19,864,811	1,334,437
	Contribution	1,147,234	1,075,019	72,215
	Interest on Contribution	88,928	83,330	5,598
	Prepayment Credit	20,808,733	20,303,820	504,913
	Interest on Prepayment	1,768,742	1,725,825	42,917
12/31/90	**Unfunded Pension Cost**	**$(2,614,389)**	**$ (3,323,183)**	**$ 708,794**

TRAVELERS INSURANCE COMPANY
HARTFORD, CONNECTICUT

STATEMENT OF CAS PENSION COSTS AND FUNDING

FOR THE PERIOD
JANUARY 1, 1986 TO JANUARY 1, 1991

FOOTNOTES

1/ We based the amortization payment on a CAS amortization schedule calculated by HCFA Office of the Actuary. That office developed the CAS amortization schedule based upon information obtained from Travelers' actuary's workpapers, valuation reports, and Internal Revenue Service (IRS) Form 5500 reports.

2/ We obtained the total company normal costs from Travelers' actuarial valuation reports and supporting workpapers. For years 1988 and after, we obtained normal costs for the Medicare segment from data files provided by Travelers' actuary.

3/ The CAS pension cost represents the sum of the amortization payment and the normal cost. We allocated the CAS pension cost to the Medicare segment based on participant salaries for years 1986 and 1987. We separately calculated CAS pension costs for years 1988, 1989, and 1990. The amounts shown for the "other segment" represent the difference between the total company and the Medicare segment.

4/ We applied 1 year's interest at the assumed rate of 8.5 percent to the CAS pension cost. We obtained the interest rate from the actuarial valuation reports.

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

6/ We obtained total company contributions from IRS Form 5500 reports. For years 1986 and 1987, we allocated contributions to the Medicare segment based on participant salaries. Travelers used this same methodology. For years 1988, 1989, and 1990, we allocated contributions to the Medicare segment based on our separate calculation of CAS pension costs.

7/ We calculated interest on the contributions based on the dates of deposit and an 8.5 percent annual interest rate. We obtained the contribution deposit dates from IRS Form 5500 reports.

TRAVELERS INSURANCE COMPANY
HARTFORD, CONNECTICUT

STATEMENT OF CAS PENSION COSTS AND FUNDING

FOR THE PERIOD
JANUARY 1, 1986 TO JANUARY 1, 1991

FOOTNOTES

8/ The unfunded pension cost represents the CAS funding target less the value of contributions and interest at year end. A negative value is a prepayment credit resulting from our calculating less CAS pension costs than contributions for the Medicare segment. Travelers may carry forward the prepayment credit to fund future CAS pension costs.

9/ The prepayment credit represents the negative unfunded CAS costs from the previous year(s). We carried forward the prepayment credit, with interest, until needed to fund future CAS pension costs.

10/ We applied 1 year's interest to the prepayment credit at the assumed rate of 8.5 percent.

TheTravelers

The Travelers Companies
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MANAGED CARE AND
EMPLOYEE BENEFITS OPERATIONS

Richard S. Stuart
Vice President
Government Programs

July 9, 1993

VIA FACSIMILE

Vincent R. Imbriani, Regional Inspector General
for Audit Services, Region VII, and
James Aasmundstad, Audit Manager
Office of Inspector General
Office of Audit Services
Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

RE: CIN: A-07-93-00665

Dear Messrs. Imbriani and Aasmundstad:

The purpose of this letter is to provide a response on behalf of The Travelers Insurance Company ("The Travelers") to a report (CIN: A-07-93-00665) entitled "Review of Unfunded Pension Costs of The Travelers Insurance Company" (the "Report") prepared by the Office of Inspector General ("OIG"), Office of Audit Services ("OAS"), on or about April 1, 1993.

The Report concluded that The Travelers, from 1986 to 1990, had accumulated approximately $1.2 million in pension costs that were unallowable for Medicare reimbursement. Additionally, the Report stated that pension costs were unallowable because they were not funded in full within the specific time periods prescribed in the Federal Acquisition Regulations ("FAR"). The Report also described that imputed interest on the unfunded pension costs would also be unallowable under such regulations.

In connection therewith, the Report recommended that The Travelers: (1) identify $1,218,963 as an unallowable component of direct pension costs as of 1991; (2) update annually the unallowable pension cost component related to the unfunded CAS (Cost Accounting Standard) costs for 1986 through 1990; and (3) identify and track unfunded pension costs occurring in later years. The Travelers cannot agree to such recommendation, however, for the reasons set forth below.

The Report does not provide an explanation with respect to the January 1, 1986 commencement date of the OIG's examination of The Travelers' unfunded pension costs. Accordingly, The Travelers hereby requests the OIG to provide an explanation for such starting point, insofar as other logical commencement dates are available.

For instance, insofar as the Report addresses only pension costs, specifically unfunded pension costs, a reasonable start date for the OIG review is the point in time the pension funding requirement as reflected in section 48 CFR 31.205-6(j)(3)(i) of the FAR became a part of the underlying contracts. It is indisputable that the funding requirement set forth in the underlying contracts and FAR existed before 1986, thus supporting an earlier commencement date for the OIG's Report. Moreover, a review of the underlying contracts, FAR and CAS do not give any indication that 1986 is the required start date of the OIG review of The Travelers' pension costs.

Alternatively, the starting point of the Report could be 1988, insofar as 1986 and 1987 are closed as evidenced by a Closing Agreement, by and between the Secretary of Health and The Travelers, dated May 19, 1990. Further, starting in 1988, The Travelers was thereafter required to separately calculate pension costs for a Medicare segment, if such calculation materially affected the amount of pension costs allocated to a segment. Previously, the Travelers determined its Medicare pension costs on a salary allocation basis.

The January 1, 1986 start date chosen by the OIG is problematic for The Travelers insofar as the calculations performed by the OIG for 1986 as reflected in the Report do not reflect a pre-payment credit generated in 1985 that would have been available to The Travelers in 1986.

In connection therewith, The Travelers has determined that in 1985, assuming the same salary allocation conducted in 1986, The Travelers deposited substantial sums in its qualified pension plan, creating an overfunding. Such amounts were proportionately larger than the CAS computed amount for pension costs. In fact, in 1985, The Travelers has estimated that it overfunded the CAS pension costs by approximately $440,000. Ordinarily, such difference would be carried forward to 1986 to fund allowable contract costs, and would be reflected in any review or audit. By beginning the review in 1986, however, the OIG has cut-off and omitted any benefits accruing in favor of The Travelers prior to such date.

It has been stated that the OIG commenced its review in 1986 insofar as the initial asset allocation was made at that time. In other words, the contract requires the initial asset allocation to be made on the first day of the first pension plan year following December 31, 1985. Note, however, that the initial asset allocation has limited impact on ongoing CAS pension costs and is unrelated to the funding requirement set forth in the FAR. The initial asset allocation simply relates to the amount of assets allocated to a Medicare segment, not whether a qualified pension plan is funded, which is the subject of the Report. Accordingly, it does not appear that 1986 is an appropriate start date of the review and Report.

In any event, it is The Travelers intent to make a formal request for a waiver from the cost assignment provisions of CAS 412.40(c) and FAR 30.412.40(c), with respect to any underfundings that may ultimately be appropriately calculated. Presently, the OIG has calculated that for 1986 and 1990, The Travelers did not fund in full the CAS pension costs within the required time periods. In the event 1986 is an erroneous starting point, however, it is likely that the underfundings calculated by the OIG, for 1986 at the very least, will disappear.

In the event such underfundings ultimately remain, however, despite the foregoing arguments, The Travelers will request a waiver authorizing the reassignment of its pension costs to later cost accounting periods. As discussed in the Report, the FAR funding requirement has been traditionally satisfied by contributions to pension plans exempt from taxation under section 501(a) of the Internal Revenue Code of 1986, as amended ("IRC"), by virtue of qualifying under IRC section 401(a). The IRC sets forth minimum funding requirements with regard to such plans at IRC section 412. Limitations on the amounts which may be contributed to such plans are also identified. Amounts contributed in excess of such limitations are subject to a 10% excise tax. <u>See</u> IRC section 404, 412 and 4972.

For Medicare reimbursement purposes, pensions costs must also be measured, assigned and allocated in accordance with CAS 412 and 413, and funded as specified in Part 31 of the FAR. The interplay of the IRC and CAS often creates inequitable results, however. Pursuant to the applicable sections of the IRC, our pension plan was fully funded in 1990. As a result, no contribution was required or permitted. However, under the CAS and FAR, according to the Report, The Travelers underfunded the CAS pension costs in 1990. The Travelers did not fund more than the maximum allowed under the IRC so as to avoid the excise tax of 10% applied to excess contributions as described above, and to avoid current loss of Federal tax deductibility. Insofar as the interaction of the IRC on the one hand, and CAS and FAR on the other hand, will generally result in a funding mismatch (i.e., an overfunding or underfunding of the CAS pension costs), The Travelers' request for a waiver will encompass similar happenings occurring in future years.

In light of the ongoing OIG audit of the indirect costs as it relates to The Travelers' qualified pension plan, and insofar as The Travelers cannot agree to the OIG's recommendations as set forth in the Report, The Travelers hereby retains the right to submit revised FACPs at such time as a final report is prepared by the OIG and is agreed to by The Travelers.

If you have any questions or comments with respect to the foregoing, please do not hesitate to contact the undersigned.

Sincerely,

Richard S. Stuart