DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date MAY 9 1994

From June Gibbs Brown
Inspector General

Subject Review of Unfunded Pension Costs of the Aetna Life Insurance Company, Hartford, Connecticut (A-07-93-00679)

To Bruce C. Vladeck
Administrator
Health Care Financing Administration

This is to alert you to the issuance on May 11, 1994 of our final audit report. A copy is attached.

Our review showed that as of January 1, 1991, Aetna Life Insurance Company (Aetna) had accumulated $4.5 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 cost 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 (ERISA) of 1974. 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.

Aetna did not make contributions to the pension trust fund for Plan Years 1986 through 1990. For each of those years, we considered CAS pension costs to be unfunded and unallowable. Considering interest on the deposits not made, Aetna has accumulated $4.5 million as of January 1, 1991 that must be separately identified and excluded as future components of Medicare pension costs.

We are recommending that Aetna: (1) separately identify $4.5 million as an unallowable component of pension costs as of January 1, 1991, (2) continue a yearly update of unallowable pension cost components related to the unfunded CAS costs for 1986 through 1990, and (3) identify and track unallowable pension costs occurring in later years.

Aetna disagreed with the finding and recommendations and plans to seek a waiver of the CAS requirements from the Health Care Financing Administration (HCFA). The HCFA regional officials agreed with our finding and recommendations.

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

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF UNFUNDED PENSION COSTS OF THE AETNA LIFE INSURANCE COMPANY

HARTFORD, CONNECTICUT

JUNE GIBBS BROWN
Inspector General

MAY 1994
A-07-93-00679

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-07-93-00679

Mr. Charles Gustafson
Assistant Vice President
Medicare Administration, M323
Aetna Life Insurance Company
151 Farmington Avenue
Hartford, Connecticut 06156

Dear Mr. Gustafson:

This report provides you with the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review titled "REVIEW OF UNFUNDED PENSION COSTS OF THE AETNA LIFE INSURANCE COMPANY, HARTFORD, CONNECTICUT." The purpose of our review was to determine whether pension costs for Plan Years 1986 through 1990 were funded in accordance with the Federal Acquisition Regulations (FAR).

As of January 1, 1991, Aetna Life Insurance Company (Aetna) had accumulated $4,455,857 in pension costs that are unallowable for Medicare reimbursement. Pension costs assigned to an accounting period, but not funded, may not be reassigned to or claimed in subsequent accounting periods. Also, interest on the portion not funded within a period cannot be a component of pension costs in any future cost accounting periods.

Aetna disagreed with our audit results. In their comments, Aetna stated Medicare reimbursement of unfunded pension costs is allowable through waivers of present CAS and FAR requirements. Aetna also disputed numerous statements about amounts recognized by them as unfunded costs and interest. We have removed all such statements since this issue is not relevant to the amount of pension cost which was unfunded at January 1, 1991. We made other changes based on their comments to this report (Appendix B) and to our report on segmentation of pension assets (A-07-93-00633).

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 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 Employees 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. If contractors deposited the minimum ERISA contribution in their qualified trust funds, and the CAS pension costs exceeded the ERISA minimum, the contractors could only claim the funded portion of the CAS amount as allowable contract costs. Additionally, the excess of the CAS costs over the ERISA minimum contribution could not be carried forward as a component of future CAS pension costs.

In contrast, 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, 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 pension 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 Aetna.

This audit was performed in conjunction with our audit of Aetna's segmentation of pension assets (A-07-93-00633). The information obtained and reviewed during that audit was also used in this audit.

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

Field work was performed from July 1992 through February 1993. Included was on-site work at Aetna's corporate offices in Hartford, Connecticut during July 1992. Subsequent audit work was performed in the OIG, OAS offices using information supplied by Aetna and the HCFA Office of the Actuary.

FINDING AND RECOMMENDATIONS

As of January 1, 1991, Aetna had accumulated $4,455,857 in unallowable direct pension costs related to its Medicare segment. These costs represent unfunded pension costs and imputed interest for Plan Years 1986 through 1990. These pension costs are unallowable because the pension costs were not funded within specific time periods set by regulation. Imputed interest on the unfunded costs is also unallowable. Aetna cannot claim any of these unfunded costs in future cost accounting periods.

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

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

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

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

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

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

In addition, the CAS within 48 CFR 30.412-50(a)(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 found that Aetna had not made contributions to its pension plan for years 1986 through 1990. For each of those years, we considered CAS pension costs to be unfunded and unallowable. Interest on the unfunded pension cost is also unallowable.

The following table shows the unfunded amounts, plus interest, which are unallowable. We computed the unfunded amount as shown on Appendix A. We increased the unfunded amount for Plan Years 1986 through 1990 by the assumed rates of interest used in the valuation reports. Our computation of the unfunded amount plus interest considers those costs which should have been funded for the applicable years.

	1986	1987	1988	1989	1990	Total
Unfunded CAS Pension Costs at Year-End	$557,819	$421,731	$722,429	$1,114,522	$1,049,149	$3,865,650
Interest to 1/1/91	229,588	124,423	135,889	100,307	0	590,207
Accumulated Unfunded Pension Costs at 1/1/91	$787,407	$546,154	$858,318	$1,214,829	$1,049,149	$4,455,857

Recommendations

We recommend that Aetna:

- o Identify $4,455,857 ($3,865,650 cost and $590,207 interest) in accumulated unfunded pension cost as unallowable components of direct pension costs as of January 1, 1991.

- o Continue a yearly update of unallowable pension cost components related to the unfunded CAS costs for 1986 through 1990.

- o Identify and track unallowable pension costs occurring in later years.

Auditee Comments

Allowability of Unfunded Costs for Medicare Reimbursement

Aetna's Position

Aetna disagreed that unfunded pension costs cannot be reimbursed by Medicare. Referring to the CAS Board's delegation of authority to waive CAS funding provisions, Aetna said: "***we have no alternative but to request a CAS waiver upon issuance of the final audit report. We feel that the unfunded pension costs under CAS are solely a timing difference and that we should be allowed to claim these costs in the future when we start funding the pension plan again."

OIG's Position

Under present CAS and FAR requirements, unfunded pension costs cannot be reimbursed by Medicare. This requirement also applies to interest on unfunded amounts. Aetna can seek redress, however, from the CAS and FAR provisions by processing a waiver request with HCFA. Waiver of the unallowable costs requires approval by HCFA.

A waiver request cannot include any interest on amounts not funded. The CAS 30.412.50(a)(7) 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." The exclusion of interest is also addressed in a May 27, 1992 memorandum from the Office of the Undersecretary of Defense. Titled "Waiver of Cost Accounting Standard (CAS) 412.40(c)," the memorandum contains guidelines which state that, in determining reassignable amounts of pension costs, "additional interest incurred on the unfunded liability, as a result of delayed funding, is unallowable."

Pension Costs 1986 - 1987

Aetna's Position

Aetna responded that, in 1986 and 1987, pension costs were computed for the Medicare segment in accordance with CAS. "Reading Appendix B of our Medicare contract, it states that this should become effective January 1, 1988 and thereafter, thus we are in disagreement with the computation to include unfunded pension costs for 1986 and 1987, computed under CAS."

OIG's Position

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 Aetna, 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 requires that Medicare contractors make the initial asset allocation as of the first day of the first pension plan year following December 31, 1985. If contractors comply with the terms of the contractual 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. We believe that the contract requires that we compute the CAS cost starting with the allocation date. We have consistently used the same CAS computation starting date for all Medicare contractors.

Computation of Unfunded
Pension Cost 1986 - 1987

Aetna's Position

Aetna's actuary questioned the computation of unfunded pension costs of $979,550 for 1986 and 1987. The actuary requested our working papers to review our computations.

OIG's Position

The requested information was sent on July 28, 1993.

INSTRUCTIONS FOR AUDITEE RESPONSE

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

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

Sincerely,

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

Enclosure

HHS Action Official:

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

AETNA LIFE INSURANCE COMPANY
HARTFORD, CONNECTICUT

STATEMENT OF CAS PENSION COST FUNDING
FOR THE PERIOD
JANUARY 1, 1986 THROUGH DECEMBER 31, 1990

Date	Description	Total Company	Other Segments	Medicare Segment	
01/01/86	Normal Cost	$28,594,317	$ -	$ -	1/
01/01/86	Amortization Payment	(7,678,321)	-	-	2/
01/01/86	CAS Pension Cost	$20,915,996	$20,404,235	$ 511,761	3/
	Interest to Year End	1,882,440	1,836,382	46,058	4/
12/31/86	CAS Funding Target	$22,798,436	$22,240,617	$ 557,819	5/
	Contributions	0	0	0	6/
12/31/86	Unfunded Pension Cost	$22,798,436	$22,240,617	$ 557,819	7/
01/01/87	Normal Cost	$30,652,713	$ -	$ -	
01/01/87	Amortization Payment	(14,657,909)	-	-	
01/01/87	CAS Pension Cost	$15,994,804	$15,607,895	$ 386,909	
	Interest to Year End	1,439,532	1,404,710	34,822	
12/31/87	CAS Funding Target	$17,434,336	$17,012,605	$ 421,731	
	Contributions	0	0	0	
12/31/87	Unfunded Pension Cost	$17,434,336	$17,012,605	$ 421,731	
01/01/88	Normal Cost	$33,747,450	$32,823,253	$ 924,197	
01/01/88	Amortization Payment	(16,941,415)	(16,679,997)	(261,418)	
01/01/88	CAS Pension Cost	$16,806,035	$16,143,256	$ 662,779	
	Interest to Year End	1,512,543	1,452,893	59,650	
12/31/88	CAS Funding Target	$18,318,578	$17,596,149	$ 722,429	
	Contributions	0	0	0	
12/31/88	Unfunded Pension Cost	$18,318,578	$17,596,149	$ 722,429	
01/01/89	Normal Cost	$38,362,692	$37,128,723	$1,233,969	
01/01/89	Amortization Payment	(20,266,172)	(20,054,700)	(211,472)	
01/01/89	CAS Pension Cost	$18,096,520	$17,074,023	$1,022,497	
	Interest to Year End	1,628,687	1,536,662	92,025	
12/31/89	CAS Funding Target	$19,725,207	$18,610,685	$1,114,522	
	Contributions	0	0	0	
12/31/89	Unfunded Pension Cost	$19,725,207	$18,610,685	$1,114,522	

AETNA LIFE INSURANCE COMPANY
HARTFORD, CONNECTICUT

STATEMENT OF CAS PENSION COST FUNDING
FOR THE PERIOD
JANUARY 1, 1986 THROUGH DECEMBER 31, 1990

Date	Description	Total Company	Other Segments	Medicare Segment
01/01/90	Normal Cost	$36,950,797	$35,758,533	$1,192,264
01/01/90	Amortization Payment	(23,496,238)	(23,266,496)	(229,742)
01/01/90	CAS Pension Cost	$13,454,559	$12,492,037	$ 962,522
	Interest to Year End	1,210,910	1,124,283	86,627
12/31/90	CAS Funding Target	$14,665,469	$13,616,320	$1,049,149
	Contributions	0	0	0
12/31/90	Unfunded Pension Cost	$14,665,469	$13,616,320	$1,049,149

FOOTNOTES

1/ We obtained the total company normal costs from Aetna's actuarial valuation reports and valuation records supplied by Aetna's actuary. We obtained normal costs for the segment from actuarial valuation records supplied by Aetna's actuary.

2/ We based the amortization payment on a CAS amortization schedule developed from information obtained from Aetna's valuation reports and IRS Form 5500 reports. We developed a separate CAS amortization schedule for the Medicare segment starting in 1988.

3/ The CAS pension cost represents the sum of the normal cost and the amortization payment. We allocated the CAS pension cost to the Medicare segment based upon participants covered salaries for years 1986 through 1987. We separately calculated the 1988 through 1990 Medicare segment's CAS pension costs. The amounts shown for "other segments" represent the difference between the total company and the Medicare segment.

4/ We applied one year's interest at the assumed rate of 9.0 percent for all years. We obtained the interest rate assumption 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/ Aetna did not make any contributions to the pension plan for Plan Years 1986 through 1990.

7/ The unfunded pension cost represents the CAS funding target less the year-end value of the contributions.

151 Farmington Avenue
Hartford, CT 06156-7380

Terrence E. Keefe, CPA
Manager
Medicare Administration, M323
Aetna Health Plans
Aetna Life Insurance Company
(203) 636-5671
Fax: (203) 636-1337

June 4, 1993

Mr. Vincent R. Imbriani
Regional Inspector General for Audit Services - Region VII
Health Care Financing Administration
New Federal Office Building
601 East 12th Street
Room 235
Kansas City, Missouri 64106

Re: Draft 01G - Pension Audit Report, dated May 5, 1993

Dear Mr. Imbriani:

Both myself and our Aetna plan actuary, Thomas Dawidowicz, have reviewed your draft Pension Audit Report dated May 5, 1993, and disagree with the following:

1. 1986 and 1987 pension costs were computed for the Medicare segment in accordance with CAS (Cost Accounting Standards). Reading Appendix B of our Medicare contract, it states that this should become effective January 1, 1988 and thereafter, thus we are in disagreement with the computation to include unfunded pension costs for 1986 and 1987, computed under CAS.

2. Mr. Dawidowicz further questions the computation of unfunded pension costs for 1986 and 1987 totaling $979,550. I am requesting that we be supplied with the workpapers computing this liability so that Mr. Dawidowicz may review these unfunded costs. Please direct these to Mr. Dawidowicz at the address indicated on his letter to me of June 2, 1993, a copy of which is attached.

3. We disagree with the statement that no contributions were made starting with 1986 due to the plan being fully funded. No contributions were made after 1984, as no minimum contribution was required and, beginning in 1987 a 10% excise penalty would be imposed had we made contributions to a fully funded plan.

4. We disagree with the statement on page 3 of Results of Audit, that Aetna recognized its noncompliance with funding requirements, and identified $3,138,065 (including imputed interest as being unallowable for future Medicare reimbursement. We did not recognize any "noncompliance with funding requirements," as we were precluded by federal tax law from making contributions after January 1, 1987. We also did not include any imputed interest with the unfunded pension cost.

5. Included on page 5 of the audit report is the audited CAS pension cost with imputed interest. Interest is precluded by FAR (Federal Acquisition Regulation) and CAS as an allowable expense. Also, there is no interest expense included in any of Mr. Dawidowicz's pension costs, thus nothing should be eliminated for interest from his calculations.

6. Finally, I as well as Mr. Dawidowicz are in disagreement with the disparity between the ERISA rules and the CAS rules concerning the unfunded pension costs, which under existing tax laws precludes us from making future contributions. As you know this has been a major area of disagreement with government contractors and the government, and the new CAS board has undertaken the task to rectify the disparity as one of its first official duties.

Due to the fact that our contract, has in Appendix B, a statement of compliance with CAS 412 and 413, concerning pension segmentation, we have no alternative but to request a CAS waiver upon issuance of the final audit report. We feel that the unfunded pension costs under CAS are solely a timing difference and that we should be allowed to claim these costs in the future when we start funding the pension plan again.

In summary, I request that Mr. Dawidowicz be supplied with the workpaper requested, and that your staff look into our areas of disagreement. I have also attached Mr. Dawidowicz's letter to me dated June 2, 1993 detailing the above points.

Should you have any further questions, please contact me or Mr. Dawidowicz at (203) 636-5671 and (203) 952-2579 respectively.

Sincerely,

Terrence E. Keefe

Terrence E. Keefe, Manager
Medicare Administration, M323
Aetna Health Plans
Aetna Life Insurance Company

TEK/ymc

Attachments

cc: N. Burke, HCFA, Boston
K. Byrne, Aetna, RT5A
T. Dawidowicz, Aetna, RT5A
H. Guerette, HCFA, Boston
C. Gustafson, Aetna, M323
P. Hamel, HCFA, Boston
D. Harmes, HHS IG Audit, Jefferson City, MO
E. Shipley, HCFA, Baltimore
K. Weissman, RW2C

Interoffice
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To Terrence E. Keefe, CPA, Manager, Medicare Administration, M323

Date June 2, 1993

Subject REVIEW OF UNFUNDED PENSION COSTS

I have reviewed the draft audit report sent to Charles Gustafson on May 5, 1993 and have several comments and points of disagreement. This audit report address the unfunded pension costs of the Medicare Segment. As with the April 29 audit report on segmentation of assets, I recommend that you respond to Mr. Imbriani and dispute the audit results.

The following are my points of disagreement:

1. This report concludes that CAS and FAR do not allow for any Medicare reimbursement for amounts not funded. I disagree with this conclusion.

    - In 1991, the CAS Board delegated authority to waive CAS pension cost assignment requirements for contractors whose over funded pension plans would otherwise subject them to a tax penalty. Aetna's pension plan has been subject to the ERISA full funding provisions since 1984. With an agency-granted waiver, Aetna can accrue pension costs, not make the payment to avoid a tax penalty, and preserve the right to seek reimbursement when the pension plan is actually funded.

      For Aetna's plan, no tax deductible contributions have been permitted during the 1984 through 1992 plan years. The 1986 Tax Reform Act established a 10% tax penalty for non-deductible contributions for plan years beginning in 1987. Thus, Aetna was precluded by Federal tax law from making any contributions to the plan for plan years after 1986. Aetna retains the right to file for this funding waiver.

- In 1992, the CAS Board issued proposed rule changes (9904.412-50) that would preserve the right to obtain reimbursement for pension plan costs that are not funded because (a) the funding would lack Federal income tax deductibility or (b) the funding would engender a tax penalty. Such deferred funding cost would have to be funded as tax laws permit, when funding resumes. Aetna meets this criteria. It has no deductible contributions and is subject to the 10% excise tax penalty.

  While these are still proposed rules and would require similar changes to FAR 31.205-6, Aetna should reserve the right to request reimbursement when these unfunded pension costs are finally funded.

2. In the opening paragraph of the May 5 draft report, Mr. Imbriani states that " the purpose of our review was to determine whether pension costs for Calendar Years 1986 through 1990 were funded in accordance with Federal Acquisition Regulations (FAR)." Yet, in the March 19, 1992 letter to Mr. Kenneth K. Kerns, Mr. Imbriani stated that "Our segmentation reviews will address the Medicare contract requirements that, beginning with Fiscal Year 1988, contractors identify, allocate, and report pension assets and costs separately for a Medicare segment." The draft report is not consistent with the ground rules outlined in that March 19th letter in that 1986 and 1987 costs are included in the draft report. We agree that assets need to be initially allocated to the Medicare segment on January 1, 1986, but any CAS and FAR unfunded costs associated with the 1986 and 1987 plan years, should be excluded from the audit report.

3. Aetna's contract with Medicare (APPENDIX B, SECTION XVI. C.) requires the contractor to separately calculate pension costs for the Medicare Segment beginning with the pension plan year starting in 1988. For Aetna's plan this is the plan year starting January 1, 1988. The requirement to include 1986 and 1987 costs is not part of this contract. Thus, pension costs for those plan years should not be considered as part of the 1992 audit.

4. As requested by the HCFA actuary, we provided Medicare participant census data for the 1986 and 1987 plan years. I assume that Mr. Shipley used that data to determine the unfunded costs for the 1986 and 1987 plan years. To date, we have not be given the opportunity to review Mr. Shipley's work papers on those years nor is there a contractual requirement to prepare such valuation work. So, I advise that you challenge those amounts. In Mr. Imbriani's letter of May 5, he asserts that the unfunded costs for 1986 and 1987 were $979,550. I have no knowledge that these amounts are reasonable.

5. In the first paragraph of the **BACKGROUND** information, Mr. Imbriani states that contributions were not made starting 1986 because the plan was fully funded. Also. Mr. Imbriani states that Aetna's actuary recommended that the plan not be funded. These background facts are not true.

   - Full funding was reached by the plan during the 1984 plan year. No tax deductible contributions were allowed from that date forward.

   - As Aetna plan actuary, I did not recommend that the plan not be funded. ERISA full funding rules required that starting with 1984, no minimum contribution was required, nor was any contribution tax deductible. With the start of the 1987 plan year, a 10% excise tax penalty precluded Aetna making any contribution to the plan.

6. In the first paragraph of RESULTS OF AUDIT on page 3 and in the summary of unfunded costs on page 5, Mr. Imbriani asserts "Aetna recognized its noncompliance with funding requirements and identified $3,138,065 (including imputed interest) as being unallowable for future Medicare reimbursement." This statement is not true.

   - Aetna did not recognize any "noncompliance with funding requirements." As noted above, Aetna was precluded by U.S. tax law from making any contributions to the plan after January 1, 1987. The unfunded costs (referred to as deferred costs in my July 9, 1992 actuarial valuation report) were calculated under the assumption that reimbursement will be available in a future fiscal year, when a tax deductible contribution is available.

   - Aetna did not impute interest on the unfunded pension costs. I am well aware that CAS 412.50 (a) (7) does not permit that interest on unfunded costs be included in any future accounting period. In my July 9, 1992 report, I determined the unfunded costs as of December 31, 1990 to be $2,895,639. I did not include the $242,426 of interest as indicated in the letter.

7. On page 5 of the report, Mr. Imbriani illustrates audited CAS pension costs with interest imputed to the end of 1990. As noted in 6. above, imputed interest is not permitted by CAS 412.50. Because CAS 412 pension cost calculations are based on the projected unit credit method and use fixed amortization amounts similar to ERISA, the lack of funding in a prior year has little effect on the future pension costs. Only the size of the asset base is affected by the lack of contributions. This has some bearing on future investment gains and losses, but not on the normal cost and actuarial accrued liability. There is no interest on unfunded pension costs included in any of my CAS 412 pension costs, thus no interest needs to be eliminated at 12/31/90 from the unfunded costs as suggested by the audit report.

In summary, I recommend that you respond to Mr. Imbriani and disagree with the results of the audit on unfunded pension costs. In my opinion, the basic premise that unfunded costs will never be reimbursable is not reasonable. Based on the 1991 CAS waiver and the 1992 CAS proposed rule changes, I believe it is reasonable to assume that the unfunded costs will be reimbursable in a future plan year. In addition, with outstanding disagreements on the original audit on asset segmentation and with a lack of documentation on HCFA determined CAS costs, it is unreasonable to accept any of the substitute CAS pension costs illustrated in this report.

Please let me know if you would like to discuss this further.

Tom

Copies: Charles Gustafson, Aetna, Medicare Administration
Kevin Byrne, Aetna, Defined Benefit Plan Services
David Diamond, Aetna, Defined Benefit Plan Services