Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF UNFUNDED PENSION COSTS OF BLUE CROSS AND BLUE SHIELD OF NORTH DAKOTA

JUNE GIBBS BROWN
Inspector General

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A-07-00-00116

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-07-00-00116
February 1, 2001

Mr. Allen Aaberg
Assistant Vice President Finance
Blue Cross and Blue Shield of North Dakota
4510 13th Avenue SW
Fargo, North Dakota 58121-0001

Dear Mr. Aaberg:

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 Blue Cross and Blue Shield of North Dakota*. The purpose of our review was to compute interest on the January 1, 1992 accumulated unfunded pension costs and to determine if pension costs allocable to the Medicare contracts for plan years 1992 through 1995 were funded in accordance with the Federal Acquisition Regulations (FAR).

During our previous review of Blue Cross and Blue Shield of North Dakota (North Dakota) (CIN: A-08-94-00740), we determined that the Medicare segment accumulated $671,198 in unfunded pension costs as of January 1, 1992. We recommended that North Dakota identify those unfunded pension costs as an unallowable component of subsequent years' pension cost calculations. We also recommended that North Dakota update the accumulated unfunded pension costs, and identify and track similar costs occurring in later years.

Our current review showed that North Dakota did not identify and update the accumulated unfunded pension costs from our prior report. North Dakota did identify and track additional unfunded pension costs for years 1992 through 1995. However, we determined that North Dakota understated its accumulated unfunded pension costs by $76,394 as of January 1, 1996. The understatement primarily occurred because North Dakota incorrectly identified the Medicare segment's accumulated unfunded pension costs from our prior report. North Dakota also began amortizing unfunded costs in 1996 without prior approval from its contracting officer.

We recommend that North Dakota increase the January 1, 1996 accumulated unfunded pension costs of the Medicare segment by $76,394. We also recommend that North Dakota obtain approval of its contracting officer before including any portion of the accumulated unfunded costs as a component of the Medicare segment's pension costs.

We also identified $173,200 of unallowable pension costs for the Medicare segment as of December 31, 1992. This occurred because North Dakota did not fully fund their 1992 pension costs with contributions. In addition, any interest on this amount is unallowable in future periods. Therefore, North Dakota has $220,207 in unallowable pension costs as of January 1, 1996.

We recommend that North Dakota identify $220,207 as an unallowable component of Medicare segment pension costs as of January 1, 1996. We also recommend that North Dakota update annually the unallowable component of pension costs related to the unfunded CAS costs for all future periods.

North Dakota concurred with our findings and recommendations. Their response to our draft audit report is included in its entirety as Appendix D.

INTRODUCTION

BACKGROUND

Cost Accounting Standards (CAS) and FAR

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 Office of Federal Procurement Policy, Cost Accounting Standards Board, revised the CAS relating to accounting for pension costs on March 30, 1995. Unless otherwise noted, the following references to the CAS refers to the standards that were in effect before the revision. For purposes of clarity, we will refer to the post revision standards as the "revised" CAS. Applicable portions of the revised CAS are discussed in a following section.

The CAS within 48 Code of Federal Regulations (CFR) 9904.412-50(a)(7) stated:

> *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 9904.412-50(a)(2) stated:

> *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....*

Furthermore, 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.

Employees Retirement Income Security Act of 1974 (ERISA)

The FAR funding requirement has traditionally been satisfied by trust fund deposits qualifying for tax-exemptions under 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 which the deposit was applicable.

Pension costs computed in accordance with the 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.

Conversely, if CAS pension costs before 1986 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.

Tax Reform Act of 1986 (TRA 86)

The 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.

Omnibus Budget Reconciliation Act of 1987 (OBRA 87)

Prior to OBRA 87, ERISA's full funding limitation traditionally considered accumulated assets and the actuarial liability. If assets equaled or exceeded the actuarial liability, the tax deductible amount was limited to zero. With OBRA 87, the Congress took additional action affecting contractors' pension plan contributions to qualified trust funds.

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.

Revised CAS

As previously noted, the CAS relating to accounting for pension costs was revised on March 30, 1995, and became applicable to contractors with the start of the first accounting period thereafter. The revised CAS removed the regulatory conflict between the funding limits of ERISA and the period assignment provisions of the CAS. The new rule allows the assignment of prior period pension costs, with interest, which were not funded because they lacked tax deductibility. However, the method or methods used to reassign the unfunded pension costs must be approved by the contracting officer.

The revision to the CAS does not remove the requirement to fund pension costs with contributions that are not in conflict with ERISA. If a contractor could have funded pension costs and chose not to, then those costs and any accrued interest on those costs are unallowable in future periods. The unallowable portion of pension costs must be updated, with interest, per FAR and CAS regulations.

OBJECTIVE, SCOPE, AND METHODOLOGY

We made our examination in accordance with generally accepted government auditing standards. Our objective was to identify any unfunded CAS costs, plus interest adjustments on the unfunded costs, from January 1, 1991 to January 1, 1996. Our objective also included identifying interest adjustments on the unfunded pension costs previously reported. Achieving our objective did not require that we review the internal control structure of North Dakota.

We performed this review in conjunction with our audit of pension segmentation (CIN: A-07-99-02560), and our review of pension costs claimed (CIN: A-07-00-00117). The information obtained and reviewed during that audit 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 North Dakota's historical practices.

We performed site work at North Dakota's corporate offices in Fargo, North Dakota during August 1999. Subsequently, we preformed audit work in our Jefferson City, Missouri office.

FINDINGS AND RECOMMENDATIONS

Unfunded CAS Pension Costs Over The ERISA Tax Maximun

As of January 1, 1996, North Dakota identified accumulated unfunded pension costs of $853,775 related to its Medicare segment. We determined that the Medicare segment's accumulated unfunded pension costs were $930,169 as of January 1, 1996. Therefore, North Dakota understated the accumulated unfunded pension costs by $76,394. This understatement occurred because North Dakota incorrectly identified the Medicare segment's accumulated unfunded pension costs from our prior report.

For plan years 1992 through 1995, North Dakota identified, tracked and updated additional Medicare segment unfunded pension costs. However, North Dakota did not properly identify and update the accumulated unfunded pension costs from our prior report. As of January 1, 1996 North Dakota identified the Medicare segment's accumulated unfunded pension costs as $853,775.

For plan years 1993 through 1997, North Dakota made contributions to its pension plan in excess of its pension costs. These contributions were sufficient to include an installment towards the accumulated unfunded pension costs. Therefore, North Dakota began amortizing the Medicare segment's accumulated unfunded costs as a component of the Plan Year 1996 segment pension costs. North Dakota amortized the unfunded costs using the methodology set forth in the revised CAS.

The revised CAS does provide for the amortization and assignment of accumulated unfunded pension costs. However, the revised CAS requires that the method or methods used to reassign the unfunded pension costs must be approved by the contracting officer. North Dakota did not receive such approval.

The HCFA Office of the Actuary computed the Medicare segment accumulated unfunded pension costs to be $930,169 as of January 1, 1996. Therefore North Dakota understated the accumulated unfunded pension costs by $76,394 ($930,169 - $853,775) as of January 1, 1996.

Unallowable Costs For Future Periods

For plan year 1993, we identified $173,200 of segment pension costs that North Dakota could have funded with contributions per ERISA, but chose not to. As of January 1, 1996, North Dakota had accumulated $220,207 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 FAR regulations. Imputed interest on the unfunded costs is also unallowable per CAS regulations. The $220,207 represents unfunded pension costs and imputed interest for plan years 1992 through 1995.

Recommendations

We recommend that North Dakota:

- Increase the accumulated unfunded pension costs of the Medicare segment by $76,394 as of January 1, 1996.
- Obtain approval from its contracting officer before including any portion of the accumulated unfunded pension costs as a component of the Medicare segment's CAS pension costs.
- Identify $220,207 as an unallowable component of direct pension costs as of January 1, 1996.
- Update annually the unallowable component of pension costs related to the unfunded CAS costs for 1992.

Auditee Response

North Dakota concurred with our findings and recommendations. Their response to our draft audit report is included in its entirety as Appendix D.

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INSTRUCTIONS FOR AUDITEE RESPONSE

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

In accordance with the principles of the Freedom of Information Act (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,

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

Enclosures

HHS Action Official:

Ms. Mary K. Smith
Regional Administrator, Region VIII
Health Care Financing Administration
1961 Stout Street
Denver, Colorado 90294-3538

BLUE CROSS BLUE SHIELD OF NORTH DAKOTA

STATEMENT OF CAS PENSION COSTS AND FUNDING

January 1, 1992 To January 1, 1996

Date	Description		Total Company	Other Segment	Medicare Segment
1/1/92	Normal Cost	1/	$1,265,614	$1,064,240	$201,374
1/1/92	Amortization Payment	2/	(521,724)	(479,249)	(42,475)
1/1/92	CAS Pension Cost	3/	743,890	584,991	158,899
	Credit Absorbed	4/	(192,110)	(192,110)	0
	CAS Funding Target	5/	551,780	392,881	158,899
1/1/92	Pre-Payment Applied	6/	0	0	0
	Interest To Year End	7/	49,660	35,359	14,301
12/31/92	Required Funding	8/	601,440	428,240	173,200
	Contribution	9/	0	0	0
	Interest to 12/31/92	10/	0	0	0
12/31/92	Under (Over) Funding	11/	$601,440	$428,240	$173,200

1/1/93	Normal Cost	$1,412,285	$1,187,803	$224,482
1/1/93	Amortization Payment	(77,812)	(71,663)	(6,149)
1/1/93	CAS Pension Cost	1,334,473	1,116,140	218,333
	Credit Absorbed	0	0	0
	CAS Funding Target	1,334,473	1,116,140	218,333
1/1/93	Pre-Payment Applied	0	0	0
	Interest To Year End	113,430	94,872	18,558
12/31/93	Required Funding	1,447,903	1,211,012	236,891
	Contribution	(1,800,249)	(1,570,014)	(230,235)
	Interest to 12/31/92	(52,042)	(45,386)	(6,656)
12/31/93	Under (Over) Funding	($404,388)	($404,388)	$0

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STATEMENT OF CAS PENSION COSTS AND FUNDING

January 1, 1992 To January 1, 1996

Date	Description	Total Company	Other Segment	Medicare Segment
1/1/94	Normal Cost	$1,668,780	$1,420,922	$247,858
1/1/94	Amortization Payment	(14,574)	(11,378)	(3,196)
1/1/94	CAS Pension Cost	1,654,206	1,409,544	244,662
	Credit Absorbed	0	0	0
	CAS Funding Target	1,654,206	1,409,544	244,662
1/1/94	Pre-Payment Applied	(404,388)	(344,578)	(59,810)
	Interest To Year End	99,985	85,197	14,788
12/31/94	Required Funding	1,349,803	1,150,163	199,640
	Contribution	(2,763,495)	(2,569,228)	(194,267)
	Interest to 12/31/92	(76,427)	(71,054)	(5,373)
12/31/94	Under (Over) Funding	($1,490,119)	($1,490,119)	$0

Date	Description	Total Company	Other Segment	Medicare Segment
1/1/95	Normal Cost	$1,781,921	$1,535,285	$246,636
1/1/95	Amortization Payment	(76,773)	(43,669)	(33,104)
1/1/95	CAS Pension Cost	1,705,148	1,491,616	213,532
	Credit Absorbed	0	0	0
	CAS Funding Target	1,705,148	1,491,616	213,532
1/1/95	Pre-Payment Applied	(1,490,119)	(1,303,515)	(186,604)
	Interest To Year End	18,277	15,988	2,289
12/31/95	Required Funding	233,306	204,089	29,217
	Contribution	(2,927,058)	(2,898,650)	(28,408)
	Interest to 12/31/92	(83,323)	(82,514)	(809)
12/31/95	Under (Over) Funding	($2,777,075)	($2,777,075)	$0

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STATEMENT OF CAS PENSION COSTS AND FUNDING

January 1, 1992 To January 1, 1996

FOOTNOTES

1/ We obtained the total company normal costs from North Dakota's actuarial valuation reports. We obtained normal costs for the Medicare segment from data files provided by North Dakota's actuary.

2/ We based the amortization payments on a CAS amortization schedule developed from information obtained from North Dakota's valuation reports and IRS Form 5500 reports.

3/ The CAS pension cost represents the sum of the normal cost and the amortization payment. We separately calculated the CAS pension cost for the Medicare segment for the years 1992 through 1995. The amounts shown for the "other segment" represent the difference between the total company and the Medicare segment.

4/ The credit absorbed represents the portion of the accumulated unabsorbed credit that is used to fund the current year CAS pension cost. The credit is used first to fund the CAS pension cost before any current or prepaid contributions are considered for funding.

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

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

7/ We applied one years' interest at North Dakota's assumed rates for each year. The assumed rates were 9% for 1992, 8.5% for 1993 and 1995, and 8% for 1994. We obtained the interest rates from North Dakota's actuarial valuation reports.

8/ The required funding represents the CAS funding target adjusted for interest earned and prepayment credits applied.

9/ North Dakota did not make a contribution to its pension plan for 1992. However, it did make contributions to the plan for years 1993 through 1995. We assigned

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STATEMENT OF CAS PENSION COSTS AND FUNDING

January 1, 1992 To January 1, 1996

the contribution to the Medicare segment based on the segment's required funding.

10/ We applied interest on the contributions from the date of deposit to the end of year using North Dakota's assumed rates of interest (same as number 7 above). We did not include any interest for deposits made to the trust fund after year-end.

11/ We computed the unfunded pension cost by subtracting the value of contributions and interest at year-end from the required funding. We calculated a prepayment credit (a negative value) in those instances where our computed CAS pension costs were less than the contributions. North Dakota may carry forward the prepayment credit to fund future CAS pension costs.

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STATEMENT OF UNALLOWABLE PENSION COSTS

January 1, 1992 To January 1, 1996

Date	Description		Total Company	Other Segment	Medicare Segment
01/01/1992	Unfunded Pension Costs	1/	$0	$0	$0
	Interest	2/	0	0	0
12/31/1992	Current Unfunded Cost	3/	601,440	428,240	173,200
01/01/1993	Unfunded Pension Costs		601,440	428,240	173,200
	Interest		51,122	36,400	14,722
01/01/1994	Unfunded Pension Costs		652,562	464,640	187,922
	Interest		52,205	37,171	15,034
01/01/1995	Unfunded Pension Costs		704,767	501,811	202,956
	Interest		59,905	42,654	17,251
01/01/1996	Unfunded Pension Costs		$764,672	$544,465	$220,207

FOOTNOTES

1/ Unfunded pension costs represent the total pension costs and accrued interest that could have been funded by North Dakota but were not. These costs are unallowable for future periods per CAS 9904.412-50(a)(7). They must be separately updated, with interest, and eliminated from any costs claimed in future periods.

2/ We applied interest to the unfunded pension costs using North Dakota's assumed rates for each year. The assumed rates were 9% for 1992, 8.5% for 1993 and 1995, and 8% for 1994. We obtained the assumed rates from North Dakota's actuarial valuation reports.

3/ Current unfunded costs represents the yearly unfunded costs. 1992 was the only year that North Dakota chose not to fully fund its pension costs.

BLUE CROSS AND BLUE SHIELD OF NORTH DAKOTA

PENSION COSTS SUBJECT TO FULL FUNDING LIMITATION

January 1, 1992 to January 1, 1996

DATE	DESCRIPTION		TOTAL COMPANY	OTHER SEGMENT	MEDICARE SEGMENT
01/01/1992	Assignable Cost Deficit	1/	$858,747	$187,547	$671,200
	Interest	2/	77,287	16,879	60,408
12/31/1992	Current Nondeductible	3/	0	0	0
01/01/1993	Assignable Cost Deficit		936,034	204,426	731,608
	Interest		79,563	17,376	62,187
12/31/1993	Current Nondeductible		0	0	0
01/01/1994	Assignable Cost Deficit		1,015,597	221,802	793,795
	Interest		81,248	17,744	63,504
12/31/1994	Current Nondeductible		0	0	0
01/01/1995	Assignable Cost Deficit		1,096,845	239,546	857,299
	Interest		93,232	20,362	72,870
12/31/1995	Current Nondeductible		0	0	0
01/01/1996	Assignable Cost Deficit		$1,190,077	$259,908	$930,169

1/ The assignable cost deficit represents the accumulated costs from prior years, with interest, that were not funded due to the ERISA tax maximum regulations. The $671,200 is $2 more than shown in our prior unfunded report CIN: A-08-94-00740. The difference is due to rounding adjustments made by the HCFA Office of the Actuary staff and we deemed it immaterial.

2/ We applied one years' interest at North Dakota's assumed rates for each year. The assumed rates were 9% for 1992, 8.5% for 1993 and 1995, and 8% for 1994.

3/ CAS pension cost for the current plan year as of December 31 of that year. These amounts were not funded because the contractor was subject to an excise tax on contributions during these periods.