DEPARTMENT OF HEALTH & HUMAN SERVICES

OFFICE OF INSPECTOR GENERAL

Office of Audit Services
Region VII
601 East 12th Street, Room 284A
Kansas City, MO 64106
(816) 426-3591

MAY 0 2 2003

Report Number: A-07-03-03039

Mr. Charles J. Reip
Manager, Financial Reporting
CareFirst of Maryland, Inc.
10455 Mill Run Circle
Owings Mills, Maryland 21117

Dear Mr. Reip:

Enclosed are two copies of the U.S. Department of Health and Human Services (HHS), Office of Inspector General, Office of Audit Services' (OAS) report entitled "*CareFirst of Maryland Unfunded Pension Costs*." A copy of this report will be forwarded to the action official noted below for his/her review and any action deemed necessary.

Final determination as to actions taken on all matters reported will be made by the HHS action official named below. 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.

In accordance with the principles of the Freedom of Information Act (5 U.S.C. 552, as amended by Public Law 104-231), OIG, OAS reports issued to the Department's grantees and contractors are made available 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.)

To facilitate identification, please refer to Report Number A-07-03-03039 in all correspondence relating to this report.

Sincerely yours,

James P. Aasmundstad
Regional Inspector General
for Audit Services

Enclosures – as stated

Directly Reply to HHS Action Official:

Ms. Sonia Madison
Regional Administrator, Region III
Centers for Medicare and Medicaid Services
The Public Ledger Building, Suite 216
150 South Independence Mall West
Philadelphia, PA 19106

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

CAREFIRST OF MARYLAND UNFUNDED PENSION COSTS

JANET REHNQUIST
INSPECTOR GENERAL

MAY 2003
A-07-03-03039

Office of Inspector General

http://oig.hhs.gov/

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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 awarding agency will make final determination on these matters.

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Office of Audit Services

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

MAY 02 2003

Report Number: A-07-03-03039

Mr. Charles J. Reip, CPA
Manager, Financial Reporting
CareFirst of Maryland, Inc.
10455 Mill Run Circle
Owings Mills, Maryland 21117

Dear Mr. Reip:

This report provides the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review titled ***CareFirst of Maryland Unfunded Pension Costs.*** We determined that CareFirst had unallowable unfunded pension costs as of January 1, 2002. The unallowable costs applicable to the Medicare segment were $80,411, and to the "Other" segment were $2,530,689. CareFirst agreed with our findings and recommendations. CareFirst's response is included as Appendix A.

EXECUTIVE SUMMARY

OBJECTIVE

The purpose of our review was 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).

- Determine if the accumulated unfunded pension costs identified in our prior review (Report Number: A-07-93-00693) have been properly accounted for.

- Identify any unallowable components of the accumulated unfunded pension costs.

FINDINGS

We found that CareFirst funded the pension costs allocable to the Medicare contracts for plan years 1992 through 1995 in accordance with FAR. However, CareFirst did not properly account for the accumulated unfunded pension costs that were identified in our prior review. CareFirst should have brought the accumulated unfunded pension costs forward, with interest, to January 1, 1996.

Effective January 1, 1996, the revised Cost Accounting Standards (CAS) allows the assignment of prior period pension costs, with interest, which were not funded because they lacked tax deductibility. However, the revision to the CAS does not remove the requirement to fund pension costs when contributions are tax deductible. 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.

We determined that a portion of CareFirst's accumulated unfunded pension costs could have been funded in the year incurred, but CareFirst chose not to fund those costs. Consequently, those unallowable costs must be updated with interest, and removed from future periods' pension cost computations. We updated the unallowable portion of CareFirst's accumulated unfunded pension costs from January 1, 1992 to January 1, 2002. We found the unallowable costs to be $80,411 for the Medicare segment, and $2,530,689 for the "Other" segment as of January 1, 2002.

RECOMMENDATIONS

We recommend that CareFirst:

- Identify $80,411 as an unallowable component of Medicare segment pension costs as of January 1, 2002.

- Identify $2,530,689 as an unallowable component of the "Other" segment's pension costs as of January 1, 2002.

- Update annually the unallowable components of pension costs for the Medicare and "Other" segments.

INTRODUCTION

BACKGROUND

CareFirst and Medicare

CareFirst administers Medicare Part A operations under cost reimbursement contracts. Previously, CareFirst also administered Medicare Part B operations. However, the Medicare Part B contract was terminated on December 31, 1994. In claiming costs, contractors were to follow cost reimbursement principles contained in the Federal Procurement Regulations (FPR), which were superseded by the Federal Acquisition Regulations (FAR) the CAS and the Medicare contracts .

Since its inception, Medicare has paid a portion of the annual contributions made by contractors to their pension plans. These payments represented allowable pension costs under the FPR and/or the FAR. In 1980, both the FPR and Medicare contracts incorporated CAS 412 and 413

CAS and 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) 30.412-50 (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.

OBJECTIVES, SCOPE AND METHODOLOGY

Objectives

Our objective was to identify any unfunded CAS costs, plus interest adjustments on the unfunded costs, from January 1, 1992 to January 1, 1996. Our objective also included identifying interest adjustments on the accumulated unfunded pension costs previously reported. An additional objective was to identify any unallowable components of the accumulated unfunded pension costs. Achieving our objective did not require that we review the internal control structure of CareFirst.

Scope

We made our examination in accordance with generally accepted government auditing standards. Our review covered the period January 1, 1992 to January 1, 2002. However, certain information obtained during our prior audit covering 1986 through 1991 was used in the conduct of this review.

We performed this review in conjunction with our audits of Medicare segmentation (Report Number: A-07-02-03033), and pension costs claimed for Medicare reimbursement (Report Number: A-07-03-03036). The information obtained and reviewed during those audits was also used in performing this review.

Methodology

The CMS, Office of the Actuary developed the methodology used for computing the CAS pension costs based on CareFirst's historical practices.

In performing the review, we used information provided by CareFirst's actuarial consulting firm. The information included liabilities, normal costs, contributions, benefit payments, investment earnings, and administrative expenses. We reviewed CareFirst's accounting records, pension plan documents, annual actuarial valuation reports, and the Department of Labor/Internal Revenue Service Form 5500s. Using these documents, CMS pension actuarial staff calculated the allowable CAS pension costs for each year 1992 through 2001, and determined the extent to which CareFirst funded those costs with contributions to the pension trust fund. We reviewed the methodology and calculations.

We performed site work at CareFirst's corporate office in Owings Mills, Maryland during October of 2002 and January of 2003. We also performed audit work in our OIG, OAS offices in Kansas City and Jefferson City, Missouri.

FINDINGS IN DETAIL

We found that CareFirst funded the pension costs allocable to the Medicare contracts for plan years 1992 through 1995 in accordance with FAR. However, CareFirst did not properly account for the accumulated unfunded pension costs that were identified in our prior review. CareFirst should have brought the accumulated unfunded pension costs forward, with interest, to January 1, 1996.

Effective January 1, 1996, the revised CAS allows the assignment of prior period pension costs, with interest, which were not funded because they lacked tax deductibility. However, the revision to the CAS does not remove the requirement to fund pension costs when contributions are tax deductible. 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.

We determined that a portion of CareFirst's accumulated unfunded pension costs could have been funded in the year incurred, but CareFirst chose not to fund those costs. Consequently, those unallowable costs must be updated with interest, and removed from future periods' pension cost computations. We updated the unallowable portion of CareFirst's accumulated unfunded pension costs from January 1, 1992 to January 1, 2002. We found the unallowable costs to be $80,411 for the Medicare segment, and $2,530,689 for the "Other" segment as of January 1, 2002.

Update of Unallowable Unfunded
January 1, 2002

Date	Description	Other Segments	Medicare Segment	Total Company
01/01/91	Prior Unallowable[1]	$1,015,190	$32,257	$1,047,447
01/01/92	Interest [2]	91,367	2,903	94,270
01/01/93	Interest	99,591	3,164	102,755
01/01/94	Interest	108,553	3,449	112,002
01/01/95	Interest	118,323	3,760	122,083
01/01/96	Interest	128,972	4,098	133,070
01/01/97	Interest	136,674	4,343	141,017
01/01/98	Interest	148,633	4,723	153,356
01/01/99	Interest	161,639	5,136	166,775
01/01/00	Interest	160,715	5,107	165,822
01/01/01	Interest	173,573	5,515	179,088
01/01/02	Interest	187,459	5,956	193,415
	Total	**$2,530,689**	**$80,411**	**$2,611,100**

[1] The prior unallowable unfunded pension costs were determined in our prior audit of CareFirst's accumulated unfunded pension costs (Report Number: A-07-93-00693)

[2] Interest was calculated on accumulated unallowable unfunded pension costs, and calculated based on the rates shown in the valuation reports.

CRITERIA

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 Medicare contract states:

> "The calculation of and accounting for pension costs charged to this agreement/contract are governed by the Federal Acquisition Regulation and Cost Accounting Standards 412 and 413."

CONDITION AND CAUSE

Unfunded CAS Pension Costs Over The ERISA Tax Maximum

During our previous review of CareFirst (Report Number: A-07-93-00693), we determined that the Medicare segment accumulated $358,998 in unfunded pension costs as of January 1, 1992. We recommended that CareFirst identify those unfunded pension costs as an unallowable component of subsequent years' pension cost calculations. We also recommended that CareFirst update the accumulated unfunded pension costs, and identify and track similar costs occurring in later years.

Our current review showed that CareFirst did not identify and update the accumulated unfunded pension costs from our prior report. As a result, CareFirst included accumulated unfunded pension costs as a component of subsequent periods' costs beginning with 1996.

Effective January 1, 1996, the revised CAS 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. CareFirst did not request or receive such approval.

Our current review showed that the Medicare segment accumulated $506,754 in unfunded pension costs (with interest) as of January 1, 1996. Of that amount, $457,123 was eligible to be reassigned to subsequent periods. However, the remaining $49,631 was an unallowable component of Medicare segment pension costs, and was not eligible for reassignment to subsequent periods.

Our current review also showed that the "Other" segment accumulated $5,511,246 in unfunded pension costs (with interest) as of January 1, 1996. Of that amount, $3,899,619 was eligible to be reassigned to subsequent periods. However, the remaining $1,611,627 was an unallowable component of "Other" segment pension costs, and was not eligible for reassignment to subsequent periods.

The "Other" segment represents all operations other than those attributable to the Medicare segment. Indirect Medicare operations are attributable to the "Other" segment. Therefore, portions of the "Other" segment's pension costs are allocable to indirect Medicare operations.

Unallowable Costs For Future Periods

As of January 1, 1996, CareFirst had accumulated $1,661,258 in unallowable pension costs (and interest) for the Medicare and "Other" segments. The pension costs are unallowable because they were not funded within specific time periods set by FAR. The unallowable pension costs are attributable to plan years 1987 through 1990. CareFirst could have funded the pension costs, as they were within ERISA maximum limits, but chose not to. Imputed interest on the unfunded costs is also unallowable per CAS regulations.

As of January 1, 2002 the unallowable costs had increased with interest to $80,411 for the Medicare segment, and $2,530,689 for the "Other" segment.

EFFECT

As of January 1, 2002, CareFirst has accumulated unfunded pension costs of $80,411 for the Medicare segment, and $2,530,689 for the "Other" segment, that is unallowable as a component of future periods' pension costs.

RECOMMENDATIONS

We recommend that CareFirst:

- Identify $80,411 as an unallowable component of Medicare segment pension costs as of January 1, 2002.

- Identify $2,530,689 as an unallowable component of the "Other" segment's pension costs as of January 1, 2002.

- Update annually the unallowable component of pension costs for the Medicare and "Other" segments.

Auditee's Comments

CareFirst agreed with our findings and recommendations. CareFirst's response is included in its entirety as Appendix A.

INSTRUCTIONS FOR AUDITEE RESPONSE

Final determinations as to actions taken on all matters reported will be made by the CMS 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 CMS action official, presenting any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act, 5 U.S.C. 552, as amended by Public Law 104-231, OIG, OAS reports are made available to the public to the extent information contained therein is not subject to the exemptions in the Act. (See CFR Part 5). As such, within 10 days after this report is issued, it will be posted on the worldwide web at http://oig.hhs.gov/.

Sincerely,

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

Enclosures

HHS Action Official

Ms. Sonia Madison
Regional Administrator, Region III
Centers for Medicare and Medicaid Services
The Public Ledger Building, Suite 216
150 South Independence Mall West
Philadelphia, PA 19106

CENTERS for MEDICARE & MEDICAID SERVICES

CareFirst of Maryland, Inc.
Medicare Part A Intermediary

April 9, 2003

James P. Aasmundstad
Office of Audit Services
Region VII
601 East 12th Street, Room 284A
Kansas City, MO 64106

Reference: **Response for Draft Report Number A-07-03-03039**

Dear Mr. Aasmundstad:

Attached is the Pension Audit Report response to the Review of CareFirst of Maryland Unfunded Pension Costs.

Finding

CareFirst did not properly account for the accumulated unfunded pension costs that were identified in our prior review. CareFirst should have brought the accumulated unfunded pension costs forward, with interest, to January 1, 1996.

Recommendation

We recommend CareFirst:

- Identify $80,411 as an unallowable component of Medicare segment pension costs as of January 1, 2002.
- Identify $2,530,689 as an unallowable component of the "Other" segment's pension costs as of January 1, 2002.
- Update annually the unallowable component of pension costs for the Medicare and "Other" segments.

CareFirst of Maryland, Inc

1946 Greenspring Drive ■ Timonium, MD ■ 21093-4141
A CMS Contracted Intermediary

Response:

CareFirst agrees with the unallowable amounts as stated in the report. We will incorporate the unallowable cost values into our calculations and update annually.

If you have questions, please call me at 410-561-4270.

Sincerely,

Stephan W. Simms
Director,
Intermediary Operations

cc: Angela Miller
Charlie Reip
Bruce Keaton
Jimmy Riggs
Cheryl Tillman, Aon
Rachel Rosenblatt. Aon

ACKNOWLEDGMENTS

Report Number: A-07-03-03039
CAREFIRST INC.

This report was prepared under the direction of James P. Aasmundstad, Regional Inspector General for Audit Services. Other principal Office of Audit Services staff that contributed include:

Greg Tambke, *Audit Manager*
James Flack, *Senior Auditor*
Dao Pham, *Auditor*
Julie Wiser, *Auditor*

For information or copies of this report, please contact the Office of Inspector General's Public Affairs office at (202) 619-1343.