DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Offices of Audit Services

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

OCT 0 4 2004

Report Number A-07-04-00165

Mr. Steven E. Kerr, CPA
Director, Financial Management Reporting
Blue Cross Blue Shield of Tennessee
801 Pine Street
Chattanooga, Tennessee 37402-2555

Dear Mr. Kerr:

Enclosed are two copies of the U.S. Department of Health and Human Services (HHS), Office of Inspector General (OIG) report entitled "Audit of Blue Cross Blue Shield of Tennessee's Unfunded Pension Costs." A copy of this report will be forwarded to the action official noted below for 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.

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If you have any questions or comments about this report, do not hesitate to call me or Jenenne Tambke, Audit Manager at (573) 893-8338, ext. 21 or through e-mail at jenenne.tambke@oig.hhs.gov. To facilitate identification, please refer to Report Number A-07-04-00165 in all correspondence relating to this report.

Sincerely yours,

James P. Aasmundstad
Regional Inspector General
for Audit Services

Enclosures – as stated

Direct Reply to HHS Action Official:

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Centers for Medicare & Medicaid Services
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Department of Health and Human Services

OFFICE OF
INSPECTOR GENERAL

AUDIT OF BLUE CROSS BLUE SHIELD OF TENNESSEE'S UNFUNDED PENSION COSTS

AUGUST 2004
A-07-04-00165

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.

EXECUTIVE SUMMARY

BACKGROUND

Blue Cross Blue Shield of Tennessee (Tennessee) administers Medicare Part A operations under a cost reimbursement contract with Centers for Medicare & Medicaid Services (CMS). Since its inception, Medicare has paid part of its contractors' pension plan costs. Costs must be funded to be allowable, unless the funding would lack tax deductibility.

Starting with Fiscal Year 1988, CMS incorporated segmentation requirements into Medicare contracts. The contract specifies segmentation requirements, and requires the separate identification of unfunded costs for the Medicare and non-Medicare (Other) segments.

OBJECTIVES

The objectives were to:

- determine if the accumulated unfunded pension costs, identified in our prior review (Report Number: A-07-94-00816), have been properly accounted for,

- determine if pension costs allocable to the Medicare contracts for plan years 1994 and 1995 were funded in accordance with Federal Acquisition Regulation (FAR), and

- identify any unallowable parts of the accumulated unfunded pension costs.

SUMMARY OF FINDINGS

Tennessee did not properly account for unfunded pension costs identified in our prior review. Unfunded pension costs identified prior to January 1, 1996 must be segmented into allowable and unallowable components. The allowable component of the unfunded pensions costs resulted from pension costs that were not funded because they were not tax deductible. The unallowable component of unfunded pension costs resulted from pension costs that were not funded because the contractor chose not to fund the costs.

However, Tennessee did fund pension costs for plan years 1994 and 1995 in accordance FAR.

The unallowable part of the Medicare segment unfunded pension costs was $173,669. The unallowable part of the Other segment unfunded pension costs was $1,402,939.

RECOMMENDATIONS

Tennessee should:

- identify $173,669 as an unallowable component of Medicare segment pension costs as of January 1, 2002,

- identify $1,402,939 as an unallowable component of the Other segment's pension costs as of January 1, 2002, and

- establish procedures to update annually the unallowable components of pension costs for the Medicare and Other segments.

AUDITEE COMMENTS

Tennessee agreed with our report. Tennessee's comments are shown in their entirety as Appendix A.

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Glossary of Abbreviations and Acronyms

CAS	Cost Accounting Standards
CFR	Code of Federal Regulations
CMS	Centers for Medicare & Medicaid Services
ERISA	Employees Retirement Income Security Act of 1974
FAR	Federal Acquisition Regulations
OBRA 87	Omnibus Budget Reconciliation Act of 1987
OAS	Office of Audit Services
TRA 86	Tax Reform Act of 1986

INTRODUCTION

BACKGROUND

Tennessee and Medicare

Tennessee administers Medicare Part A operations under a cost reimbursement contract. In claiming costs, contractors were to follow cost reimbursement principles contained in FAR, Cost Accounting Standards (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 FAR. In 1980, the Medicare contracts incorporated CAS 412 and 413

CAS

CAS deals with stability between contract periods and requires that pension costs be consistently measured and assigned to contract periods. The Office of Federal Procurement Policy, Cost Accounting Standards Board, revised CAS relating to accounting for pension costs on March 30, 1995. Unless otherwise noted, the following references to 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 the following section.

CAS within 48 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, 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...."

FAR

FAR addresses the allowability of pension costs and requires that pension costs assigned to contract periods be substantiated by funding. 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)

FAR funding requirement has traditionally been satisfied by trust fund deposits qualifying for tax-exemptions under ERISA. 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 CAS represented an assignment of pension costs to specific accounting periods. CAS pension costs often fell between ERISA minimum and maximum contributions. If contractors deposited the minimum ERISA contribution in their qualified trust funds, and CAS pension costs exceeded ERISA minimum, the contractors could only claim the funded portion of CAS amount as allowable contract costs. Additionally, the excess of CAS costs over 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 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)

TRA 86 changed the effect of making pension plan contributions in excess of ERISA maximums. 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, Congress took additional action affecting contractors' pension plan contributions to qualified trust funds.

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, 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 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 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 objectives were to determine if Tennessee's prior accumulated unfunded pension costs had been properly accounted for; whether Tennessee funded pension costs in accordance with Federal Acquisition Regulations (FAR) for plan years 1994 and 1995; and to identify any unallowable parts of the accumulated unfunded pension costs.

Scope

Our review covered the period January 1, 1994 to January 1, 2002. However, certain information obtained during our prior audit covering 1986 through 1993 was used in performing this review. Achieving our objectives did not require a review of Tennessee's internal control structure.

We performed this review in conjunction with our audits of Medicare segmentation (Report Number: A-07-03-03043), and pension costs claimed for Medicare reimbursement (Report Number: A-07-04-03054). The information obtained and reviewed during those audits was also used in performing this review.

We performed site work at Tennessee's corporate office in Chattanooga, Tennessee.

Methodology

In performing the review, we used information provided by Tennessee's actuarial consulting firm. The information included assets, liabilities, normal costs, contributions, benefit payments, investment earnings, and administrative expenses. We reviewed Tennessee'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 1994 through 2001, and determined the extent to which Tennessee funded those costs with contributions to the pension trust fund. We reviewed the methodology and calculations.

We made our examination in accordance with generally accepted government auditing standards.

FINDINGS AND RECOMMENDATIONS

Tennessee did not properly account for the accumulated unfunded pension costs that were identified in our prior review. Tennessee should have brought the accumulated unfunded pension costs forward, with interest, to January 1, 1996. However, Tennessee did fund the pension costs allocable to the Medicare contracts for plan years 1994 and 1995 in accordance with FAR.

A portion of Tennessee's accumulated unfunded pension costs could have been funded in the year incurred, but Tennessee 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 Tennessee's accumulated unfunded pension costs from January 1, 1994 to January 1, 2002. We found the unallowable costs to be $173,669 for the Medicare segment, and $1,402,939 for the Other segment as of January 1, 2002.

Update of Unallowable Unfunded Pension Costs
January 1, 2002

Date	Description	Other Segment	Medicare Segment	Total Company
01/01/94	Prior Unallowable[1]	$ 720,475	$ 89,188	$ 809,663
01/01/95	Interest [2]	57,638	7,135	64,773
01/01/96	Interest	66,140	8,187	74,327
01/01/97	Interest	71,762	8,883	80,645
01/01/98	Interest	77,862	9,638	87,500
01/01/99	Interest	89,449	11,073	100,522
01/01/00	Interest	97,500	12,069	109,569
01/01/01	Interest	106,274	13,156	119,430
01/01/02	Interest	115,839	14,340	130,179
	Total	**$1,402,939**	**173,669**	**1,576,608**

CRITERIA: CAS

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:

[1] The prior unallowable unfunded pension costs were determined in our prior audit of Tennessee's accumulated unfunded pension costs (Report Number: A-07-94-00816).

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

> "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: UPDATE OF PRIOR UNFUNDED CAS PENSION COSTS

Prior Unfunded CAS Pension Costs

Our previous review of Tennessee found that the Medicare segment accumulated $352,026 in unfunded pension costs as of January 1, 1994. We recommended that Tennessee identify and update the unfunded pension costs for any later years in a similar manner.

Tennessee did not identify and update the accumulated unfunded pension costs from our prior report. As a result, Tennessee 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.

The Medicare segment accumulated $412,504 in unfunded pension costs (with interest) as of January 1, 1996. Of that amount, $307,994 was eligible to be reassigned to subsequent periods. However, the remaining $104,510 was an unallowable component of Medicare segment pension costs, and was not eligible for reassignment to subsequent periods.

The Other segment accumulated $8,907,747 in unfunded pension costs (with interest) as of January 1, 1996. Of that amount, $8,063,494 was eligible to be reassigned to subsequent periods. However, the remaining $844,253 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 After CAS Revision

As of January 1, 1996, Tennessee had accumulated $948,763 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 1986 through 1993. Tennessee 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 $173,669 for the Medicare segment, and $1,402,939 for the Other segment.

CAUSE: LACK OF ADEQUATE CONTROLS

Tennessee had not established procedures to properly account for the accumulated unfunded pension costs.

EFFECT: UNALLOWABLE UNFUNDED PENSION COSTS

As of January 1, 2002, Tennessee has accumulated unfunded pension costs of $173,669 for the Medicare segment, and $1,402,939 for the Other segment, that is unallowable as a component of future periods' pension costs.

RECOMMENDATIONS

Tennessee should:

- identify $173,669 as an unallowable component of Medicare segment pension costs as of January 1, 2002;

- identify $1,402,939 as an unallowable component of the Other segment's pension costs as of January 1, 2002; and

- establish procedures to annually update the unallowable component of pension costs for the Medicare and Other segments.

AUDITEE COMMENTS

Tennessee agreed with our report. Tennessee's comments are shown in their entirety as Appendix A.

Appendix

BlueCross BlueShield
of Tennessee

801 Pine Street
Chattanooga, Tennessee 37402-2555

www.bcbst.com

August 16, 2004

Mr. James P. Aasmundstad
Regional Inspector General for Audit Services
DHHS/OIG/OAS
601 East 12th Street, Room 284A
Kansas City, Missouri 64106

Subject: Contractor (BlueCross BlueShield of Tennessee) Responses to Draft Audit Reports

Dear Mr. Aasmundstad:

We have reviewed and are responding to the following draft audit reports:

Pension Segmentation (Report No. A-07-04-0343) - Our pension actuaries, Chicago Consulting Actuaries (CCA) and our Human Resources personnel have reviewed this report. We agree with the report. CCA has supplied their response to this report with the following commitment: "...CCA intends to apply the recommendation that Medicare segment assets be reduced by this amount in the future cost reimbursement calculations". BlueCross BlueShield of Tennessee (BCBST) has already outlined procedural enhancements that will provide several levels of review for Medicare personnel listings being sent to CCA for use in the segmentation calculation process.

Unfunded Pension Costs (Report No. A-07-04-00165) - The CCA actuaries have reviewed this report and have responded as follows: "We agree with the findings described in report 00165...CCA intends to apply the recommendation that these amounts be reflected in future cost reimbursement calculations." BCBST will be following up with reviews and discussions with CCA to assure that all changes are completed.

Pension Costs Claimed (Report No. A-07-04-03054) – Taking into consideration the issues and conclusions drawn from the Segmentation Report, BCBST agrees with this report. We are ready to make appropriate FACP adjustments to clear all outstanding pension cost variances upon receipt of final directions. With the corrective actions associated with the Segmentation Report, differences of this nature will be self-correcting. We await further feedback from the actuaries associated with this audit, who indicated during their onsite visit that the unclaimed undercharges from the previous audit (CIN: A-07-94-00815) would be taken into account and addressed in this audit.

Supplemental Executive Retirement Program (SERP) Costs Claimed (Report No. A-07-04-00164) – We have reviewed the report and the quoted Cost Accounting Standards and we concur with the audit finding. We will be adjusting the appropriate FACPs for the fiscal years 1994 through 2002. We are modifying our financial procedures to include an on-going tracking report that will provide amortization data for our Medicare cost reporting.

We appreciate the professionalism exhibited by the OIG team association with this audit. Please keep us informed as to any revisions to these draft reports.

Sincerely,

Harold H. Cantrell, Jr.
Vice President, Finance

cc: Steve Kerr, Dir., Financial Mgmt. Rptg.
David Deal, Sr. VP and CFO