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

JUN 0 6 2005

Report Number A-07-05-00186

Donald L. Fisher, Vice President
Compensation, Benefits, HRIS, and Risk Management
Highmark, Inc.
1800 Center Street
P.O. Box 890089
Camp Hill, Pennsylvania 17089-0089

Dear Mr. Fisher:

Enclosed are two copies of the Department of Health and Human Services (HHS), Office of Inspector General (OIG) report entitled "Review of Postretirement Benefit Costs Claimed by Veritus, Inc. of Pennsylvania" for the period covering fiscal years 1995 through 1997. A copy of this report will be forwarded to the HHS action official noted on the next page for her review and any action deemed necessary.

The action official will make final determination regarding actions taken on all matters in the report. We request that you respond to the 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 reports are made available publicly to the extent information contained therein is not subject to exemptions of the Act that the Department chooses to exercise. (See 45 CFR part 5.)

If you have any questions or comments about this report, please do not hesitate to call me at (816) 426-3591, ext. 225, or Jenenne Tambke, Audit Manager, at (573) 893-8338, ext. 21, or through email at Jenenne.Tambke@oig.hhs.gov. Please refer to report number A-07-05-00186 in all correspondence.

Sincerely yours,

James P. Aasmundstad
Regional Inspector General
for Audit Services

Enclosures

Direct Reply to HHS Action Official:

Nancy B. O'Connor
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Centers for Medicare & Medicaid Services
Public Ledger Building, Suite 216
150 South Independence Mall West
Philadelphia, Pennsylvania 19106

Department of Health and Human Services

OFFICE OF
INSPECTOR GENERAL

REVIEW OF POSTRETIREMENT BENEFIT COSTS CLAIMED BY VERITUS, INC. OF PENNSYLVANIA

JUNE 2005
A-07-05-00186

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

Veritus, Inc. of Pennsylvania (Veritus) administered Medicare Part A operations under a cost reimbursement contract with the Centers for Medicare & Medicaid Services (CMS) from the inception of the Medicare program until it merged with Pennsylvania Blue Shield (PBS) on December 6, 1996, to form Highmark, Inc. (Highmark). This report will address findings related to Veritus.

Before 1995, Veritus accounted for and claimed postretirement benefit (PRB) costs under a pay-as-you-go method. However, beginning January 1, 1995, Veritus began to account for and claim PRB costs using accrual accounting, and it established a Voluntary Employee Benefit Association (VEBA) trust for the purpose of funding the accrued costs pursuant to Federal regulations.

CMS reimburses a portion of its contractors' PRB costs. In claiming PRB costs, contractors must follow cost reimbursement principles contained in the Federal Acquisition Regulations (FAR) and applicable Cost Accounting Standards (CAS) as required by their Medicare contracts. Furthermore, the Medicare contract and the Budget Performance Requirements require that any change in accounting practice for PRB costs be submitted to CMS in advance for approval.

OBJECTIVE

Our objective was to determine the allowability of the PRB costs Veritus claimed for Medicare reimbursement on an accrual basis for fiscal years (FY) 1995 through 1997.

SUMMARY OF FINDINGS

Veritus did not include in its Final Administrative Cost Proposals (FACPs) all of the PRB costs that were allowable pursuant to Federal regulations. As a result, for FYs 1995 through 1997, Veritus did not claim $201,785 of PRB costs that were allowable for Medicare reimbursement.

In addition, Veritus did not receive CMS approval for its change in accounting methodology for PRB costs.

RECOMMENDATIONS

Veritus should revise its FACPs for FYs 1995 through 1997 or submit a claim for additional allowable PRB costs of $201,785.

After addressing the issues raised under Other Matters, Veritus should seek approval for its change in accounting practice.

AUDITEE'S COMMENTS

Veritus's comments are summarized in the following paragraphs and presented in their entirety as Appendix D.

Veritus agreed with our recommendation to revise its FACPs for FYs 1995 through 1997 or submit a claim for additional allowable PRB costs of $201,785. Additionally, Veritus agreed that it did not seek CMS approval for its change in accounting methodology for PRB costs.

However, Veritus disagreed with our statement in the Other Matters section that Veritus should be precluded from including unfunded PRB costs in any future claims to the Federal Government. Veritus believes that by requiring contractors to use FAS106 in calculating PRB costs, the FAR irreconcilably conflicts with the Internal Revenue Service limitations on VEBA funding.

OFFICE OF INSPECTOR GENERAL RESPONSE

We are aware that Veritus and CMS are engaged in discussions concerning the unfunded PRB costs addressed in the Other Matters section. However, Veritus did not calculate the PRB cost to be assigned to the cost accounting period pursuant to the accrual accounting guidelines in FAR 31.205-6(o)(2)(iii). Therefore, we maintain that Veritus should address the issues raised under Other Matters.

TABLE OF CONTENTS

Glossary of Abbreviations and Acronyms

CAS	Cost Accounting Standards
CMS	Centers for Medicare & Medicaid Services
FACP	Final Administrative Cost Proposal
FAR	Federal Acquisition Regulations
FY	fiscal year
HHS	U.S. Department of Health and Human Services
Highmark	Highmark, Inc.
LOB	Line of Business
OIG	Office of the Inspector General
PBS	Pennsylvania Blue Shield
PRB	Postretirement Benefit
SFAS	Statement of the Financial Accounting Standards Board
VEBA	Voluntary Employee Benefit Association
Veritus	Veritus, Inc. of Pennsylvania

INTRODUCTION

BACKGROUND

Medicare

Veritus, Inc. of Pennsylvania (Veritus) s administered Medicare Part A operations under a cost reimbursement contract with the Centers for Medicare & Medicaid Services (CMS) from the inception of the Medicare program until it consolidated with Pennsylvania Blue Shield (PBS) on December 6, 1996, to form Highmark, Inc. (Highmark). CMS reimburses a portion of its contractors' postretirement benefit (PRB) costs. In claiming PRB costs, contractors must follow cost reimbursement principles contained in the Federal Acquisition Regulations (FAR) and applicable Cost Accounting Standards (CAS) as required by their Medicare contracts. Before 1995, Veritus accounted for and claimed PRB costs under a pay-as-you method. However, beginning January 1, 1995, Veritus began to account for and claim PRB costs using accrual accounting, and it established a Voluntary Employee Benefit Association (VEBA) trust for the purpose of funding the accrued costs pursuant to Federal regulations.

Regulations

The FAR sets forth the allowability requirements and applicable methods of accounting for PRB costs under a government contract. PRB costs can include, but are not limited to postretirement health care, life insurance provided outside a pension plan, and other welfare benefits, such as tuition assistance, day care, legal services, and housing subsidies provided after retirement. PRBs do not cover retirement income and ancillary benefits, such as life insurance, paid by pension plans during the period following the employees' retirement.

The FAR 31 requires contractors to choose one of three accounting practices (pay-as-you go, accrual, or terminal) for measuring and assigning PRB costs to accounting periods. However, the Medicare contract and the Budget Performance Requirements require that any change in accounting practice for such pension and/or PRB costs must be submitted to CMS in advance for approval.

The FAR further states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof. Furthermore, costs of retiree insurance must comply with the standards promulgated by the CAS Board. The CAS requires that the allocation of PRB costs to cost objectives be based on the beneficial or causal relationship between the PRB costs and the corresponding cost objectives.

In 1990, the issuance of the Statement of Financial Accounting Standard (SFAS) 106 required contractors to report in their financial statements the accrued liability for PRBs for current and retired employees, and set forth specific guidance on the accrual methodology to be used. However, the FAR allows contractors the option of electing accrual accounting following SFAS 106 methodology for funded PRBs, or of continuing to recognize PRB costs on a cash basis for government contract purposes if that had been their practice.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

Our objective was to determine the allowability of the PRB costs Veritus claimed for Medicare reimbursement on an accrual accounting basis for fiscal years (FY) 1995 through 1997.

Scope

We reviewed PRB costs claimed for Medicare reimbursement on Veritus's FACPs for FYs 1995 through 1997. Achieving the objective did not require that we review Veritus's overall internal control structure. However, we did review the controls relating to the PRB costs claimed for Medicare reimbursement to ensure that costs were allowable pursuant to the FAR.

We conducted fieldwork at Highmark's corporate office in Camp Hill, PA.

Methodology

We identified Veritus's PRB costs for the total company and the portion allocable to the Medicare segment. We also determined the extent to which Veritus funded the PRB costs with contributions to the VEBA trust fund or with direct payment of benefits. In performing our review, we used information provided by Veritus's actuarial consulting firm. Because Veritus had not followed SFAS 106 to develop PRB costs as required by the FAR, the CMS Office of the Actuary developed PRB costs for Veritus based on SFAS 106 methodology pursuant to the FAR. Using this information, we calculated the PRB costs that were allowable for Medicare reimbursement for FYs 1995 through 1997. Appendix A contains the details of the PRB costs and contributions.

We performed this review in conjunction with our audits of pension segmentation (A-07-04-00168), pension costs claimed for reimbursement (A-07-04-00170), and unfunded pension costs (A-07-04-00175). We used the information obtained and reviewed during those audits in performing this review.

Our audit was performed in accordance with generally accepted government auditing standards.

FINDINGS AND RECOMMENDATIONS

Veritus did not include in its FACPs all of the PRB costs that were allowable pursuant to Federal regulations. As a result, for FYs 1995 through 1997, Veritus did not claim $201,785 of PRB costs that were allowable for Medicare reimbursement.

In addition, Veritus did not receive CMS approval for its change in accounting methodology for PRB costs.

FEDERAL ACQUISITION REGULATIONS & COST ACCOUNTING STANDARDS

The FAR states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof, and must comply with the applicable standards promulgated by the CAS Board. Additionally, the CAS requires that the allocation of PRB costs to cost objectives be based on the beneficial or causal relationship between the PRB costs and corresponding cost objectives.

MEDICARE CONTRACT & BUDGET AND PERFORMANCE REQUIREMENTS

Since 1993, the Budget and Performance Requirements instructions sent to Medicare contractors by CMS have included a reminder of the special provisions regarding costs of PRB plans. The Budget Performance Requirements specified that any change in accounting practice for PRB costs must be submitted to CMS in advance for approval.

ALLOWABLE POSTRETIREMENT BENEFIT COSTS

For FYs 1995 through 1997, Veritus did not claim PRB costs that were allowable for Medicare reimbursement. Veritus failed to claim all of the accrued PRB costs that had been funded through deposits to the VEBA trust. Our calculation showed that Veritus underclaimed PRB costs by $201,785. The following schedule provides a comparison of allowable PRB costs as calculated by Veritus and the Office of Inspector General (OIG). Details underlying this schedule may be found in the appendixes to this report.

Veritus PRB Costs Claimed Variance

FY	Per OIG	Per Veritus	Difference
1995[1]	$141,843	$71,807	$70,036
1996	121,668	158,900	(37,232)
1997	184,481	15,500	168,981
Total	**$447,992**	**$246,207**	**$201,785**

ACCOUNTING PRACTICE CHANGE

Beginning January 1, 1995, Veritus switched from accounting for PRB costs on a pay-as-you-go basis to accounting for costs on an accrual basis without CMS approval.

RECOMMENDATIONS

Veritus should revise its FACPs for FYs 1995 through 1997 or submit a claim for additional allowable PRB costs of $201,785.

After addressing the issues raised under Other Matters, Veritus should seek approval for its change in accounting practice.

[1]FY 1995 only covers January 1, 1995, through September 30, 1995. The costs claimed on the FACP per Veritus have been adjusted to reflect this time period.

OTHER MATTERS

Veritus based its claim for PRB costs on the amount accrued and funded for the cost accounting period with the tax-deductible contribution to its VEBA. Veritus did not calculate the PRB cost to be assigned to the cost accounting period pursuant to the accrual accounting guidelines in FAR 31.205-6(o)(2)(iii). There was no accounting for the unfunded portion of the PRB cost assigned to the cost accounting period.

We compared the PRB costs calculated by the CMS Office of the Actuary to actual contributions. We found that Veritus accumulated unfunded PRB costs, plus interest, of $16,425,000 as of January 1, 1997. The following table shows the unfunded amounts and interest, which are unallowable on a cumulative basis. (Details of amounts that were not funded and the accumulation of such unfunded costs may be found in the appendixes to this report.)

Unfunded PRB Costs and Interest

Fiscal Year	Unfunded PRB Costs	Interest to 1/1/97	Total as of 1/1/97
1995	$4,703,000	$1,181,000	$5,884,000
1996	5,611,000	888,000	6,499,000
1997	3,743,000	299,000	4,042,000
Total	**$14,057,000**	**$2,368,000**	**$16,425,000**

Veritus should track this amount and ensure that the unfunded PRB costs are not included in any future claims.

AUDITEE'S COMMENTS

Veritus's comments are summarized in the following paragraphs and presented in their entirety as Appendix D.

Veritus agreed with our recommendation to revise its FACPs for FYs 1995 through 1997 or submit a claim for additional allowable PRB costs of $201,785. Additionally, Veritus agreed that it did not seek CMS approval for its change in accounting methodology for PRB costs.

However, Veritus disagreed with our statement in the Other Matters section that Veritus should be precluded from including unfunded PRB costs in any future claims to the Federal Government. Veritus believes that by requiring contractors to use FAS106 in calculating PRB costs, the FAR irreconcilably conflicts with the Internal Revenue Service limitations on VEBA funding.

OIG RESPONSE

We are aware that Veritus and CMS are engaged in discussions concerning the unfunded PRB costs addressed in the Other Matters section. However, Veritus did not calculate the PRB cost to be assigned to the cost accounting period pursuant to the accrual accounting guidelines in FAR 31.205-6(o)(2)(iii). Therefore, we maintain that Veritus should address the issues raised under Other Matters.

APPENDIXES

VERITUS, INC.
STATEMENT OF ALLOWABLE POST RETIREMENT BOARD COSTS
FOR FISCAL YEARS 1995 THROUGH 1997
REPORT NUMBER A-07-05-00186

Date	Description		Total Company	Other Segment	Medicare Segment
1995	Total Contributions to Trust Fund	1/	$ 1,291,000		
8.00%	Discount for Interest	2/	(96,000)		
01/01/1995	Present Value of Trust Fund Contributions	3/	1,195,000		
1995	Total Direct Benefit Payments	4/	1,293,000		
8.00%	Discount for Interest	5/	(50,000)		
01/01/1995	Present Value of Direct Benefit Payments	6/	1,243,000		
01/01/1995	Prepayment Credit Applied	7/	0		
01/01/1995	PV of Direct Benefit Payments Applied	8/	1,243,000		
01/01/1995	PV of Trust Fund Contributions Applied	9/	1,195,000		
01/01/1995	Funded Net Postretirement Benefit Cost	10/	2,438,000		
1995	Allowable Interest on Direct Benefit Payments	11/	50,000		
1995	Allowable Interest on Contributions	12/	68,000		
1995	Total Allowable & Allocable PRB Cost	13/	2,556,000		
1995	Headcount Percentages	14/	100.00%	94.66%	5.34%
1995	Allocable PRB Costs	15/	2,556,000	$2,419,625	$136,375
1995	Fiscal Year PRB Costs 19/	16/		1,814,718	102,282
1995	Medicare LOB Percentage	17/		2.18%	100.00%
1995	**Medicare Allowable PRB Costs**	18/	**$141,843**	**$39,561**	**$102,282**

Date	Description	Total Company	Other Segment	Medicare Segment
1996	Total Contributions to Trust Fund	$966,000		
7.25%	Discount for Interest	(65,000)		
01/01/1996	Present Value of Trust Fund Contributions	901,000		
1996	Total Direct Benefit Payments	982,000		
7.25%	Discount for Interest	(35,000)		
01/01/1996	Present Value of Direct Benefit Payments	947,000		
01/01/1996	Prepayment Credit Applied	0		
01/01/1996	PV of Direct Benefit Payments Applied	947,000		
01/01/1996	PV of Trust Fund Contributions Applied	901,000		
01/01/1996	Funded Net Postretirement Benefit Cost	1,848,000		
1996	Allowable Interest on Direct Benefit Payments	35,000		
1996	Allowable Interest on Contributions	46,000		
1996	Total Allowable & Allocable PRB Cost	1,929,000		
1996	Headcount Percentages	100.00%	95.78%	4.22%
1996	Allocable PRB Costs	1,929,000	$1,847,671	$81,329
1996	Fiscal Year PRB Costs		1,990,660	95,090
1996	Medicare LOB Percentage		1.37%	99.27%
1996	**Medicare Allowable PRB Costs**	**$121,668**	**$27,272**	**$94,396**

VERITUS, INC.
STATEMENT OF ALLOWABLE POST RETIREMENT BOARD COSTS
FOR FISCAL YEARS 1995 THROUGH 1997
REPORT NUMBER A-07-05-00186

Date	Description	Total Company	Other Segment	Medicare Segment
1997	Total Contributions to Trust Fund	$2,041,000		
8.00%	Discount for Interest	-147,000		
01/01/1997	Present Value of Trust Fund Contributions	1,894,000		
1997	Total Direct Benefit Payments	1,373,000		
8.00%	Discount for Interest	-53,000		
01/01/1997	Present Value of Direct Benefit Payments	1,320,000		
01/01/1997	Prepayment Credit Applied	0		
01/01/1997	PV of Direct Benefit Payments Applied	1,320,000		
01/01/1997	PV of Trust Fund Contributions Applied	1,894,000		
01/01/1997	Funded Net Postretirement Benefit Cost	3,214,000		
1997	Allowable Interest on Direct Benefit Payments	53,000		
1997	Allowable Interest on Contributions	107,000		
1997	Total Allowable & Allocable PRB Cost	3,374,000		
1997	Headcount Percentages	100.00%	96.31%	3.69%
1997	Allocable PRB Costs	3,374,000	$ 3,249,543	$ 124,457
1997	Fiscal Year PRB Costs		2,899,075	113,675
1997	Medicare LOB Percentage		2.56%	97.00%
1997	**Medicare Allowable PRB Costs**	**$184,481**	**$74,216**	**$110,264**

FOOTNOTES

1/ Total contributions to the trust fund are the net deposits made to the Voluntary Employee Benefit Association (VEBA) trust fund. Such contributions can be used to satisfy the funding requirements of Federal Acquisition Regulations (FAR) 31.205-6(o)(2)(iii) and Cost Accounting Standards (CAS) 416-50(a)(1)(v)(A).

2/ Interest is determined using the Statement of the Financial Accounting Standards Board (SFAS) 106 expected long-term rate of return. For 1995, there were no assets at the beginning of 1995, and no assumption made for the expected long-term rate of return for SFAS 106 purposes. Therefore, the expected long-term rate was set equal to 8.00 percent, which was the 1995 SFAS 106 discount rate.

3/ The present value of trust fund contributions is the value of the contributions discounted from the date of deposit into the VEBA back to the first day of the plan year.

4/ Direct benefit payments are amounts paid directly to or on behalf of plan beneficiaries. Direct benefit payments must be considered towards the funding of the Postretirement Benefit (PRB) cost assigned to the period before considering the amount funded by contributions to the trust fund in accordance with CAS 416-50(a)(1)(iv)(C). In effect, the benefit payments that reduce the recognized accumulated postretirement benefit obligation are deemed liquidated on a cash accounting basis in accordance with FAR 31.205-6(o)(2)(i).

5/ Interest is determined using the SFAS 106 expected long-term rate of return.

6/ Direct benefit payments are discounted to the first day of the plan year at the expected long-term rate of return assuming the benefit payments are made evenly throughout the year, that is, on average all payments are assumed to be made in the middle of the year.

FOOTNOTES (Continued)

7/ Any accumulated value of prepayment credits are applied towards the funding of the accrued current net postretirement benefit cost, as developed in Appendix C, immediately. The accumulated value of prepayments credits is available as of the first day of the plan year to the cost assigned to the period. FAR 31.205-6(o)(4) states that any increased cost interest due to delayed funded is unallowable. For the period 1995 through 1997, the accumulated value of prepayment credits was zero (see Appendix C).

8/ Present value of direct benefit payments are applied towards current period funding up to the amount of the accrued current net postretirement benefit cost assigned to the period reduced for any prepayment credits that have been applied. Such direct payments are considered funding of the cost assigned to the period before considering the amount funded by contributions (fund deposits) in accordance with CAS 416-50(a)(1)(iv)(C).

9/ Present value of trust fund contributions are applied towards current period funding up to the amount of the accrued current net postretirement benefit cost reduced for any prepayment credits and present value of direct benefit payments that have been applied. Such contributions can be used to satisfy the funding requirements of FAR 31.205-6(o)(2)(iii) and CAS 416-50(a)(1)(v)(A).

10/ The allowable and allocable PRB cost is the sum of the prepayment credits, present value of direct benefit payments, and present value of trust fund contributions that have been applied. This is the value of the allowable and allocable PRB cost for the period as of the first day of the plan year before considering any allowable interest on the direct benefit payments and trust fund contributions. The allowable and allocable PRB cost can not exceed the accrued net postretirement benefit cost for the period.

11/ Direct benefit payments are deemed to be paid as the costs are incurred by and on behalf of plan beneficiaries, and therefore no adjustment for delayed funding is necessary. The allowable interest on direct benefit payments is the amount of the discount for interest prorated by the present value of direct benefit payments applied to the present value of direct benefit payments.

12/ The allowable interest on trust fund contributions is the lesser of the actual interest incurred or the maximum allowable interest. The actual interest incurred for trust fund contributions applied is the amount of the discount for interest prorated by the present value of trust fund contributions applied to the present value of total trust fund contributions. FAR 31.205-6(o)(4) disallows interest caused by not funding within 30 days of the end of each quarter. Therefore, the maximum allowable interest is the amount of interest that would be incurred if the total contribution were made in four installments at 4 months, 7 months, 10 months, and 13 months after the first day of the plan year.

13/ The total allowable and allocable PRB cost is the allowable and allocable PRB cost as of the first day of the plan year plus allowable interest on direct benefit payments and trust fund contributions. This is the amount of postretirement benefit costs that may be allocated to final cost objectives, such as Medicare contracts, as an allowable cost.

14/ The headcount percentages used to allocate the total allowable PRB costs are developed from the active and retired plan participant data obtained as part of our audit of pension segmentation (A-07-04-00168).

15/ Total allocable PRB costs are allocated to the Medicare and other segments based on the headcount percentage of the intermediate cost objectives.

16/ We converted the allocable PRB costs determined on a plan year basis to a Federal fiscal year (FY) basis (October 1 through September 30). We calculated the fiscal year PRB costs as 1/4 of the prior plan year's costs plus 3/4 of the current plan year's costs. Costs charged to the Medicare contract should consist of the Medicare segment's direct PRB costs plus PRB costs attributable to indirect Medicare operations.

FOOTNOTES (Continued)

17/ The is the portion of each segment's allowable PRB costs that can be allocated to the Medicare contract as a final cost objective. We obtained the percentages from documents provided by Veritus.

18/ We calculated allowable PRB costs of the Medicare and other segments based on the Medicare line-of-business (LOB) percentage of each segment.

19/ PRB costs for FY 1995 only cover the period 01/01 to 09/30/1995. The amounts shown as claimed by Veritus in the audit report also only cover the period 01/01 to 09/30/1995. PRB costs claimed on a pay-as-you-go basis for the first quarter of FY 1995 (10/01/1994 - 12/31/1995) are outside the scope of this audit.

VERITUS, INC.
STATEMENT OF ACCUMULATED VALUES OF UNFUNDED ACCRUALS
FOR PLAN YEARS 1995 THROUGH 1997
REPORT NUMBER A-07-05-00186

Date	Description		Total Company
01/01/1995	Prior Accumulated Value of Unfunded Accruals	1/	$0
01/01/1995	Value of Current Year Underfunding	2/	4,703,000
01/01/1995	Accumulated Value of Unfunded Accruals		4,703,000
1995	Expected Long-Term Rate of Return	3/	8.00%
	Interest to End of Year at Expected Rate		376,000
12/31/1995	**Accumulated Value of Unfunded Accruals**	4/	**$5,079,000**

Date	Description		Total Company
01/01/1996	Prior Accumulated Value of Unfunded Accruals	5/	$5,079,000
01/01/1996	Value of Current Year Underfunding		5,611,000
01/01/1996	Accumulated Value of Unfunded Accruals		10,690,000
1996	Expected Long-Term Rate of Return	6/	7.25%
	Interest to End of Year at Expected Rate		775,000
12/31/1996	**Accumulated Value of Unfunded Accruals**		**$11,465,000**

Date	Description	Total Company
01/01/1997	Prior Accumulated Value of Unfunded Accruals	$11,465,000
01/01/1997	Value of Current Year Underfunding	3,743,000
01/01/1997	Accumulated Value of Unfunded Accruals	15,208,000
1997	Expected Long-Term Rate of Return	8.00%
	Interest to End of Year at Expected Rate	1,217,000
12/31/1997	**Accumulated Value of Unfunded Accruals**	**$16,425,000**

FOOTNOTES

1/ Accrual accounting was not used for prior accounting periods, thus the accumulated value of prior unfunded accruals is zero.

2/ See Appendix C

3/ Due to the lack of assets at the beginning of 1995, there was no assumption made for the expected long-term rate of return for SFAS 106 purposes. Therefore, the expected long-term rate was set equal to 8.00 percent, which was the 1995 SFAS 106 discount rate.

4/ Accumulated value of unfunded accruals is adjusted for interest at the expected long-term rate of return to the end of the plan year. Unfunded accruals, which are unallowable in future periods in accordance with FAR 31.205-6(o)(3), are adjusted for interest to eliminate the unallowable increased cost due to delayed funding as required by FAR 31.205-6(o)(4).

5/ The prior accumulated value of unfunded accruals as of the first day of the current year is the accumulated value of unfunded accruals as of the last day of the prior year.

6/ Source: SFAS 106 Valuation reports for 1996 and 1997

VERITUS, INC.
STATEMENT OF POST RETIREMENT BENEFIT COST FUNDING
FOR PLAN YEARS 1995 THROUGH 1997

Date	Description		Total Company
12/31/1995	Service Cost	1/	$2,440,000
12/31/1995	Interest Cost	2/	3,228,000
	Net Return on Adjusted Assets Value		
1995	Expected Return on Plan Assets	3/	0
1995	Expected Return on Prior Unfunded Accruals	4/	0
1995	Expected Return on Prepayment Credits	5/	0
	Amortization of Unrecognized Balances		
1995	Amortization of Initial Transition Obligation	6/	2,044,000
1995	Amortization of Past Service Cost	7/	0
1995	Amortization of (Gains) or Losses	8/	0
12/31/1995	Accrued Current Net Postretirement Benefit Cost	9/	7,712,000
1995	Expected Long-Term Rate of Return	10/	8.00%
	Interest Adjustment to the Beginning of the Year		(571,000)
01/01/1995	Accrued Current Net Postretirement Benefit Cost	11/	7,141,000
01/01/1995	Prepayment Credit Applied	12/	0
01/01/1995	Current Period Funding Requirement	13/	7,141,000
01/01/1995	Present Value of Current Year Direct Benefit Payments	14/	(1,243,000)
01/01/1995	Present Value of Current Year Trust Fund Contributions	15/	(1,195,000)
01/01/1995	**Value of Current Year Underfunding (Prepayment)**	16/	**$4,703,000.00**

Date	Description		Total Company
12/31/1996	Service Cost		$3,151,000
12/31/1996	Interest Cost		3,278,000
	Net Return on Adjusted Assets Value		
1996	Expected Return on Plan Assets		(105,000)
1996	Expected Return on Prior Unfunded Accruals		(368,000)
1996	Expected Return on Prepayment Credits		0
	Amortization of Unrecognized Balances		
1996	Amortization of Initial Transition Obligation		2,044,000
1996	Amortization of Past Service Cost	17/	0
1996	Amortization of (Gains) or Losses	18/	0
12/31/1996	Accrued Current Net Postretirement Benefit Cost		8,000,000
1996	Expected Long-Term Rate of Return	19/	7.25%
	Interest Adjustment to the Beginning of the Year		(541,000)
01/01/1996	Accrued Current Net Postretirement Benefit Cost		7,459,000
01/01/1996	Prepayment Credit Applied		0
01/01/1996	Current Period Funding Requirement		7,459,000
01/01/1996	Present Value of Current Year Direct Benefit Payments		(947,000)
01/01/1996	Present Value of Current Year Trust Fund Contributions		(901,000)
01/01/1996	**Value of Current Year Underfunding (Prepayment)**		**$5,611,000**

VERITUS, INC.
STATEMENT OF POST RETIREMENT BENEFIT COST FUNDING
FOR PLAN YEARS 1995 THROUGH 1997

Date	Description		Total Company
12/31/1997	Service Cost		$2,797,000
12/31/1997	Interest Cost		3,834,000
	Net Return on Adjusted Assets Value		
1997	Expected Return on Plan Assets		(244,000)
1997	Expected Return on Prior Unfunded Accruals		(917,000)
1997	Expected Return on Prepayment Credits		0
	Amortization of Unrecognized Balances		
1997	Amortization of Initial Transition Obligation	**20/**	2,044,000
1997	Amortization of Past Service Cost		0
1997	Amortization of (Gains) or Losses		0
12/31/1997	Accrued Current Net Postretirement Benefit Cost		7,514,000
1997	Expected Long-Term Rate of Return		8.00%
	Interest Adjustment to the Beginning of the Year		(557,000)
01/01/1997	Accrued Current Net Postretirement Benefit Cost		6,957,000
01/01/1997	Prepayment Credit Applied		0
01/01/1997	Current Period Funding Requirement		6,957,000
01/01/1997	Present Value of Current Year Direct Benefit Payments		(1,320,000)
01/01/1997	Present Value of Current Year Trust Fund Contributions		(1,894,000)
01/01/1997	**Value of Current Year Underfunding (Prepayment)**		**$3,743,000**

FOOTNOTES

1/ For 1997, the report was prepared for Highmark - West. SFAS 106 describes the service cost component of net postretirement benefit cost as "the portion of expected postretirement benefit obligation attributed to employee service during that period."

2/ SFAS 106 measures the interest cost component of net postretirement benefit cost as the accumulated postretirement benefit obligation, adjusted for expected benefit payments, multiplied by the discount rate "to recognize the passage of time."

3/ SFAS 106, as modified by SFAS 132, measures the expected return on plan assets component of net postretirement benefit cost by applying the expected long-range rate return to the fair value of plan assets at the beginning of the period, adjusted for expected benefit payments and contributions.

4/ Interest due to delayed funding is unallowable under FAR 31.205-6(o)(4). The expected return on plan assets is increased by interest at the assumed expected long-term rate of return on the accumulated value of unfunded accruals to eliminate the effect of the underfunding.

5/ The expected return on plan assets is decreased by interest at the assumed expected long-term rate of return on the accumulated value of prepayment credits to adjust for the effect of the premature funding. This accounting recognition treats prepaid and unfunded postretirement benefit costs on a consistent basis.

FOOTNOTES (Continued)

6/ This is the amortization of the transition obligation component of net postretirement benefit cost. The transition obligation is the unfunded accumulated postretirement benefit obligation existing at the date SFAS 106 accrual accounting methodology is first adopted for Government contract costing purposes. The transition obligation is amortized in accordance the delayed recognition provisions of paragraphs 112 and 113 of SFAS 106 as required by FAR 31.205-6(o)(5) and consistent with CAS 416-50(a)(1)(v)(C). As permitted by paragraph 112 of SFAS 106, the transition obligation is amortized over 20 years instead of the average future years of service. Use of this longer amortization period minimizes the occurrences of unallowable unfunded postretirement benefit costs.

7/ This is the initial period for which accrual accounting is adopted for government contract costing purposes, and the transition obligation is based on the current plan provisions. Therefore, there is no past service cost recognized for the current period, and the amortization of past service cost component of net postretirement benefit obligation cost is zero.

8/ This is the initial period for which accrual accounting is adopted for government contract costing purposes. The transition obligation is based on the current assets and plan provisions, and there is no gain and loss from prior periods. The amortization of gains and losses component of net postretirement benefit obligation cost is zero.

9/ The accrued current net postretirement benefit cost is the sum of the various components of net postretirement benefit cost, including the expected returns on unfunded accruals and prepayment credits. This is the amount of cost assigned to the cost accounting period and measured as of the last day of the plan year.

10/ Due ot the lack of plan assets at the beginning of 1995, there was no assumption made for the expected long-term rate of return for SFAS 106 purposes. Therefore, the expected long-term rate is set equal to 8.00 percent, which is the SFAS 106 discount rate for 1995.

11/ The accrued current net postretirement benefit cost as of the last day of the plan year is discounted to the first day of the plan year at the expected long-term rate of return.

12/ Since the accumulated value of prepayments credits is available as of the first day of the plan year to the cost assigned to the period, any prepayment credits are applied towards the funding of the accrued current net postretirement benefit cost immediately. FAR 31.205-6(o)(4) states thatany increased cost due to delayed funded is unallowable.

13/ Any accrued current net postretirement benefit cost remaining after application of the accumulated value of prepayments credits must be funded by deposits to the plan assets or direct payments to plan beneficiaries.

14/ Benefit payments made directly to or on behalf of plan beneficiaries are discounted to the first day of the plan year at the expected long-term rate of return assuming the benefit payments are made evenly throughout the year. Direct benefit payments that reduce the recognized accumulated postretirement benefit obligation are deemed liquidated on a cash accounting basis in accordance with FAR 31.205-6(o)(2)(i).

15/ Contributions are discounted from the date of deposit to the first day of the plan year at the expected long term rate of return. Such contributions can be used to satisfy the funding requirements of FAR 31.205-6(o)(2)(iii) and CAS 416-50(a)(1)(v)(A).

FOOTNOTES (Continued)

16/ The portion of the accrued current net postretirement benefit cost assigned to the period that is not funded within the tax-filing deadline as required by FAR 31.205-6(o)(3) is unallowable. Unfunded PRB costs are accumulated with interest and are not allowable in any subsequent periods. Underfunding is shown as a positive value. A prepayment credit is created when the funding by prepayment credits, direct benefit payments, and contributions exceeds the cost assigned to the current period. Prepayment credits are accumulated and carried forward, with interest, to fund future PRB costs in future periods. Prepayments are shown with a negative sign.

17/ For 1996 and 1997, there is no past service cost recognized for SFAS 106 purposes.

18/ As required by FAR 31.205-6(o)(2)(iii), the SFAS 106 methodology for determining the gains or losses is followed. The value of gains and losses are determined based on the unrecognized transition obligation, unrecognized past service cost, and plan assets, adjusted for the accumulated values of unfunded accruals and prepayments, determined for government contract costing purposes.

19/ Source: SFAS 106 Valuation reports for 1996 and 1997.

20/ SFAS 106 requires that when years of future service are eliminated by an early retirement window, a proportionate share of the unrecognized transition obligation be immediately recognized and offset with a corresponding gain or loss. However, for government contract costing purposes, FAR 31.205-6(o)(5) does not provide for any change in the amortization of the transition obligation. Similarly, CAS 416-50(a)(1)(v)(C) requires the cost of retiree insurance programs to be spread over the future years of service, without exception. Therefore, for government contract costing purposes, neither the unrecognized transition obligation nor its remaining amortization period is adjusted.

HIGHMARK

May 12, 2005

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

RE: A-07-05-00186 "Review of Postretirement Benefit Costs Claimed by Veritus, Inc. of Pennsylvania"

Dear Mr. Aasmundstad:

Attached is our response to your letter dated February 24, 2005, requesting comments on your draft report A-07-05-00186 entitled, "Review of Postretirement Benefit Costs Claimed by Veritus, Inc. of Pennsylvania," for the period covering fiscal years 1995 through 1997.

If you have any questions, please feel free to contact me at 717-302-4175.

Sincerely,

Donald L. Fisher

Donald L. Fisher, Vice President
Compensation, Benefits, HRIS &
Risk Management

DLF/per
Enclosure:

cc: Elizabeth Farbacher
Patrick Kiley
Gayeta Porter

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LHP-004 (R3-00) 31003

Review of Postretirement Benefit Costs Claimed by Veritus, Inc. of Pennsylvania

Fiscal Years 1995 through 1997

Highmark's Comments to OIG Draft Report A07-05-00186

05/11/2005

HIGHMARK'S COMMENTS ON REPORT NUMBER A-07-05-00186

The draft audit report indicates that Veritus, Inc. did not include in its FACPs all of the PRB costs that were allowable pursuant to Federal regulations (an additional $201,785 of PRB cost for FYs 1995-1997 should be claimed). Highmark agrees to accept this finding.

The draft audit report notes that Veritus, Inc. did not receive CMS approval for its change in accounting methodology for PRB costs. Highmark searched the permanent records file and was not able to locate documentation from CMS approving the change in accounting methodology for PRB adopted by Veritus, Inc. in 1995. Given the 10-year lapse of time since the PRB change, the turnover of key personnel, as well as the consolidation of Veritus, Inc. and Pennsylvania Blue Shield in late 1996, we are unable to identify or trace any documented actions that Veritus, Inc. may have taken to discuss or inform CMS of this change. Therefore, we will not disagree with this finding.

In the "Other Matters" section of the draft audit report, OIG identifies $16,425,000 in unfunded PRB costs and interest as of January 1, 1997, that Veritus, Inc. did not calculate in accordance with the "accrual accounting guidelines in FAR 31.205-6(o)(2)(iii)" (i.e.,FAS 106). OIG recommends that Veritus, Inc. should be precluded from including these unfunded PRB costs in any future claims to the Government.

Highmark disagrees with OIG's recommendation on the ground that by requiring contractors to use FAS 106 in calculating PRB costs, the FAR irreconcilably conflicts with the IRS limitations on VEBA funding. This FAR provision, therefore, is inconsistent with the fundamental principle underlying cost-reimbursement contracts generally and Medicare contracts specifically – full reimbursement of a contractor's reasonable, allowable and allocable costs.

Highmark and CMS currently are engaged in discussions concerning this issue, and Highmark will provide a written submission directly to CMS setting forth its position and its recommendations to mitigate or resolve the conflict.