Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF UNFUNDED PENSION COSTS OF BLUE CROSS OF WASHINGTON AND ALASKA

JUNE GIBBS BROWN
Inspector General

MARCH 1997
CIN: A-07-97-01206

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-07-97-01206

MAR 18 1997

Mr. Kenneth Hamm
Vice President of Finance
Blue Cross of Washington and Alaska
7001 220th Street S.W.
Mountlake Terrace, WA 98043-2124

Dear Mr. Hamm:

This report provides the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review titled *Review of Unfunded Pension Costs of Blue Cross of Washington and Alaska*. The purpose of our review was to determine if pension costs for Plan Years 1986 through 1995 were funded in accordance with the Federal Acquisition Regulations (FAR).

Blue Cross of Washington and Alaska (Washington/Alaska) did not make contributions to the pension trust fund for Plan Years 1986, and 1988 through 1993. Accordingly, Washington/Alaska did not fund the pension costs identifiable with its Medicare segment during this period. As a result, Washington/Alaska accumulated unfunded pension costs of $106,843 as of January 1, 1996. Washington/Alaska must separately identify and eliminate this amount from the amortization components of future pension costs. Washington/Alaska agreed that there are accumulated unfunded pension costs of $106,843 as of January 1, 1996. Washington/Alaska's response is included in its entirety as Appendix B.

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

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

In addition, the CAS within 48 CFR 9904.412-50(a)(2) states:

> *Pension costs applicable to prior years that were specifically unallowable in accordance with then existing Government contractual provisions shall be separately identified and eliminated from any unfunded actuarial liability being amortized....*

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 for which the deposit was applicable.

Pension costs computed in accordance with CAS represented an assignment of pension costs to specific accounting periods. The CAS pension costs often fell between ERISA minimum and maximum contributions. If contractors deposited the minimum ERISA contribution in their qualified trust funds, and the CAS pension costs exceeded the ERISA minimum, the contractors could only claim the funded portion of the CAS amount as allowable contract costs. Additionally, the excess of the CAS costs over the ERISA minimum contribution could not be carried forward as a component of future CAS pension costs.

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 equalled 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.

SCOPE

We made our examination in accordance with generally accepted government auditing standards. Our objective was to identify any unfunded CAS costs, plus appreciation on the unfunded costs, from January 1, 1986 to January 1, 1996. Achieving our objective did not require that we review the internal control structure of Washington/Alaska.

We performed this review in conjunction with our audits of pension segmentation (CIN: A-07-96-01189) and pension costs claimed for Medicare reimbursement (CIN: A-07-97-01205). The information obtained and reviewed during those audits 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 Washington/Alaska's historical practices.

We performed site work at Washington/Alaska's corporate offices in Mountlake Terrace, Washington during August 1996. Subsequently, we performed audit work in our Jefferson City, Missouri Office.

FINDING AND RECOMMENDATIONS

As of January 1, 1996, Washington/Alaska had accumulated $106,843 in unallowable direct pension costs related to its Medicare segment. These costs represent unfunded pension costs and imputed interest for Plan Years 1986 through 1995.

Washington/Alaska did not make contributions to the pension trust fund in Plan Years 1986, and 1988 through 1993 because the pension plan was fully funded. Washington/Alaska's actuary recommended in the actuarial valuation reports for those years that the plan not be funded.

The CAS pension costs not funded were unallowable as a component of pension costs for any future years. Imputed interest on the unfunded costs is also unallowable. In addition, the unfunded costs cannot be claimed in future cost accounting periods.

We compared CAS pension costs for the Medicare segment, computed by HCFA Office of the Actuary, to actual contributions to the Medicare segment. We found that the Medicare segment had accumulated unfunded pension costs, plus interest, of $106,843 for plan years 1986 through 1995. The following table shows the unfunded amounts, and interest, which were unallowable on a cumulative basis.

Unfunded CAS Pension Costs and Interest

Year	Unfunded CAS Costs	Interest To 1/1/96	Total As Of 1/1/96
1986	$26,704	$29,978	$ 56,682
1987	13,141	12,565	25,706
1988	3,726	2,959	6,685
1989	0	0	0
1990	0	0	0
1991	0	0	0
1992	0	0	0
1993	15,165	2,605	17,770
1994	0	0	0
1995	0	0	0
Total	$58,736	$48,107	$106,843

Our computation of the unfunded amounts plus interest considered those costs which should have been funded for the applicable years. In other words, if Washington/Alaska funded the costs, the assets of the Medicare segment would have been greater. Appendix A provides additional information on the CAS pension costs.

Recommendations

We recommend that Washington/Alaska:

1. Identify $106,843 as an unallowable component of direct pension costs as of January 1, 1996.

2. Update annually the unallowable pension cost component related to the unfunded CAS costs for Plan Years 1986 through 1995.

3. Identify and update unfunded pension costs for any later years in a similar manner.

Auditee Response

Washington/Alaskan agreed with the recommendation that there are accumulated unfunded pension costs of $106,843 as of January 1, 1996. Washington/Alaska plans to seek a reassignment of these unfunded pension costs under the revised CAS 412 and 413.

OTHER MATTERS

The Office of Federal Procurement Policy, Cost Accounting Standards Board, revised the CAS relating to accounting for pension costs effective March 30, 1995. The revised CAS removes the regulatory conflict between the funding limits of ERISA and the period assignment provisions of the CAS. Additionally, the new rule will allow 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.

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 each of 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.

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

Sincerely,

Barbara A. Bennett
Regional Inspector General
for Audit Services

Enclosures

HHS Action Official:

MS. Nancy Dapper
Regional Administrator, Region X
Health Care Financing Administration
2201 Sixth Ave.
Mail Stop RX40
Seattle, Washington 98121-2500

BLUE CROSS OF WASHINGTON AND ALASKA

CIN: A-07-97-01206

STATEMENT OF CAS PENSION COSTS AND FUNDING
JANUARY 1, 1986 TO JANUARY 1, 1996

Description		Total Company	Other Segment	Medicare Segment
01/01/86 Normal Cost	1/	$1,068,408	$1,015,072	$53,336
01/01/86 Amortization Payment	2/	(609,260)	(580,423)	(28,837)
01/01/86 CAS Pension Cost	3/	459,148	434,649	24,499
Interest to 12/31/86	4/	41,323	39,118	2,205
12/31/86 CAS Funding Target	5/	500,471	473,767	26,704
Contribution		0	0	0
Interest to 12/31/86		0	0	0
12/31/86 Unfunded Pension Cost	6/	$500,471	$473,767	**$26,704**
01/01/87 Normal Cost		$1,540,255	$1,472,834	$67,421
01/01/87 Amortization Payment		(443,175)	(422,396)	(20,779)
01/01/87 CAS Pension Cost		1,097,080	1,050,438	46,642
Interest to 12/31/87		93,252	89,287	3,965
12/31/87 CAS Funding Target		1,190,332	1,139,725	50,607
Contribution	7/	(869,116)	(832,166)	(36,950)
Interest to 12/31/87	8/	(12,130)	(11,614)	(516)
12/31/87 Unfunded Pension Cost		$321,216	$295,945	**$13,141**
01/01/88 Normal Cost		$1,312,598	$1,264,815	$47,783
01/01/88 Amortization Payment		(970,728)	(926,363)	(44,365)
01/01/88 CAS Pension Cost		341,870	338,452	3,418
Interest to 12/31/88		30,768	30,460	308
12/31/88 CAS Funding Target		372,638	368,912	3,726
Contribution		0	0	0
Interest to 12/31/88		0	0	0
12/31/88 Unfunded Pension Cost		$372,638	$368,912	**$3,726**

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JANUARY 1, 1986 TO JANUARY 1, 1996

Description	Total Company	Other Segment	Medicare Segment
01/01/89 Normal Cost	$1,394,430	$1,348,646	$45,784
01/01/89 Amortization Payment	(1,067,546)	(1,020,714)	(46,832)
01/01/89 CAS Pension Cost	326,884	327,932	(1,048)
Interest to 12/31/89	29,420	29,514	(94)
12/31/89 CAS Funding Target	356,304	357,446	(1,142)
Contribution	0	0	0
Interest to 12/31/89	0	0	0
12/31/89 Unfunded Pension Cost	$356,304	$357,446	**$(1,142)**
01/01/90 Normal Cost	$1,532,335	$1,485,558	$46,777
01/01/90 Amortization Payment	(1,276,456)	(1,220,067)	(56,389)
01/01/90 CAS Pension Cost	255,879	265,491	(9,612)
Interest to 12/31/90	23,029	23,894	(865)
12/31/90 CAS Funding Target	278,908	289,385	(10,477)
Contribution	0	0	0
Interest to 12/31/90	0	0	0
12/31/90 Unfunded Pension Cost	$278,908	$289,385	**$(10,477)**
01/01/91 Normal Cost	$1,646,386	$1,594,685	$51,701
01/01/91 Amortization Payment	(1,222,801)	(1,167,828)	(54,973)
01/01/91 CAS Pension Cost	423,585	426,857	(3,272)
Interest to 12/31/91	38,123	38,417	(294)
12/31/91 CAS Funding Target	461,708	465,274	(3,566)
Contribution	0	0	0
Interest to 12/31/91	0	0	0
12/31/91 Unfunded Pension Cost	$461,708	$465,274	**$(3,566)**

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STATEMENT OF CAS PENSION COSTS AND FUNDING
JANUARY 1, 1986 TO JANUARY 1, 1996

Description		Total Company	Other Segment	Medicare Segment
01/01/92 Normal Cost		$1,721,386	$1,663,641	$57,745
01/01/92 Amortization Payment		(1,334,193)	(1,276,872)	(57,321)
01/01/92 CAS Pension Cost		387,193	386,769	424
01/01/92 Absorbed Credit	9/	(424)	0	(424)
Interest to 12/31/92		34,809	34,809	0
12/31/92 CAS Funding Target		421,578	421,578	0
Contribution		0	0	0
Interest to 12/31/92		0	0	0
12/31/92 Unfunded Pension Cost		$421,578	$421,578	**$0**
01/01/93 Normal Cost		$1,654,675	$1,582,418	$72,257
01/01/93 Amortization Payment		(1,216,998)	(1,176,070)	(40,928)
01/01/93 CAS Pension Cost		437,677	406,348	31,329
01/01/93 Absorbed Credit		(17,352)	0	(17,352)
Interest to 12/31/93		35,728	34,540	1,188
12/31/93 CAS Funding Target		456,053	440,888	15,165
Contribution		0	0	0
Interest to 12/31/93		0	0	0
12/31/93 Unfunded Pension Cost		$456,053	$440,888	**$15,165**
01/01/94 Normal Cost		$1,753,403	$1,676,206	$77,197
01/01/94 Amortization Payment		(1,119,711)	(1,072,872)	(46,839)
01/01/94 CAS Pension Cost		633,692	603,334	30,358
Interest to 12/31/94		50,695	48,266	2,429
12/31/94 CAS Funding Target		684,387	651,600	32,787
Contribution		(2,183,071)	(2,150,880)	(32,191)
Interest to 12/31/94		(40,361)	(39,765)	(596)
12/31/94 Unfunded Pension Cost		$(1,539,045)	$(1,539,045)	**$0**

BLUE CROSS OF WASHINGTON AND ALASKA

CIN: A-07-97-01206

STATEMENT OF CAS PENSION COSTS AND FUNDING
JANUARY 1, 1986 TO JANUARY 1, 1996

Description	Total Company	Other Segment	Medicare Segment
01/01/95 Normal Cost	$1,513,882	$1,430,324	83,558
01/01/95 Amortization Payment	(1,596,003)	(1,539,265)	(56,738)
01/01/95 CAS Pension Cost	(82,121)	(108,941)	26,820
Interest to 12/31/95	(6,980)	(9,260)	2,280
12/31/95 CAS Funding Target	(89,101)	(118,201)	29,100
Contribution	(1,443,986)	(1,414,886)	(29,100)
Interest to 12/3/95	0	0	0
12/31/95 Unfunded Pension Cost	$(1,533,087)	$(1,533,087)	**$0**

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STATEMENT OF CAS PENSION COSTS AND FUNDING
JANUARY 1, 1986 TO JANUARY 1, 1996

FOOTNOTES

1/ We obtained the total company normal cost from Washington/Alaska's actuarial valuation reports. We obtained normal cost for the Medicare segment from data files provided by Washington/Alaska's actuary. The amount shown for the "other segment" represents the difference between the total company and the Medicare segment.

2/ We based the amortization payment on a CAS amortization schedule developed from information obtained from Washington/Alaska's valuation reports and IRS Form 5500 reports. The amortization payment was negative for years in which pension assets exceeded actuarial liabilities, thereby creating a negative unfunded actuarial liability.

3/ The CAS pension cost represents the sum of the amortization payment and the normal cost. We allocated the CAS pension cost to the Medicare segment based on the ratio of the individual participant's normal cost and accrued liability to the total company normal cost and accrued liability for years 1986 and 1987. We separately calculated CAS pension costs for years 1988 through 1995.

4/ We applied one year's interest at the assumed rate of 9.0 percent for years 1988 through 1992, 8.5 percent for 1987, 1993, and 1995, and 8.0 percent for 1994 to the CAS pension cost. We obtained the interest rates from the actuarial valuation reports.

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

6/ The unfunded pension cost represents the CAS funding target less the value of contributions. We calculated an unabsorbed credit (a negative value) where our computed CAS pension cost was negative. Washington/Alaska must carry forward the unabsorbed credit and offset it against future positive CAS pension costs.

7/ Washington/Alaska did not make contributions to its pension plan for years 1986, and 1988 through 1993. However, it did make contributions to the pension plan for years 1987 and 1994. For 1987 we assigned contributions to the Medicare segment based on the ratio of the individual participant's normal cost and accrued liability to the total company normal cost and accrued liability. For 1994 we assigned contributions to the Medicare segment based on a ratio of Medicare segment's CAS funding target to the total company CAS funding target.

8/ We calculated interest on the contributions, from the date of deposit to the end of the year, at the assumed rates of interest (see footnote 4/).

BLUE CROSS OF WASHINGTON AND ALASKA

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STATEMENT OF CAS PENSION COSTS AND FUNDING
JANUARY 1, 1986 TO JANUARY 1, 1996

9/ The absorbed credit represents the carry forward of the prior year(s) negative CAS pension costs. The unabsorbed credit is unallowable for Medicare reimbursement and must be offset against future positive CAS pension costs until it is completely absorbed.

Blue Cross
of Washington and Alaska

An Independent Licensee of the
Blue Cross and Blue Shield Association

P. O. Box 327
Seattle, Washington 98111-0327

March 10, 1997

Ms. Barbara A. Bennett
Regional Inspector General for Audit Services
Region VII
Office of Inspector General
Department of Health and Human Services
601 East 12th Street, Room 284A
Kansas City, MO 64106

Re: CIN: A-07-96-01189
A-07-97-01205
A-07-97-01206

Dear Ms. Bennett:

We have reviewed the draft findings of the Office of Inspector (OIG) Medicare Audit.

We agree with the recommendation (CIN: A-07-96-01189) that Blue Cross of Washington and Alaska adjust the Medicare segment assets by $96,740 as of January 1, 1995.

We agree with the findings (CIN: A-07-97-01205) that for fiscal years 1993, 1994 and 1995 that $15,688 in excess pension costs over the allowable CAS pension costs were claimed. After the final audits have been issued, we will take the necessary steps to revise the FACPs for these years.

We agree with the recommendation (CIN: A-07-97-01206) that there are accumulated unfunded pension costs of $106,843 as of January 1, 1995. After the final audits have been issued, we will be seeking a reassignment of these costs under the revised CAS 412 and 413. At that time, we will work with HCFA's Office of the Actuary and Blue Cross and Blue Shield Association to reassign these costs to future periods.

Sincerely,

D. Christensen

Donna C. Christensen

cc: HCFA Seattle Regional Office
Eric Shipley, HCFA, Office of the Actuary (7500 Security Blvd., N3-01-21,
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Robert Rhodes, BCBSA
Carol Navin, NEBA