Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

AUDIT OF THE PENSION PLAN AT A TERMINATED MEDICARE CONTRACTOR, BLUE CROSS AND BLUE SHIELD OF KANSAS CITY

JUNE GIBBS BROWN
Inspector General

JULY 1998
CIN: A-07-97-02503

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-07-97-02503
July 13, 1998

Ms. Marilyn Tromans
Vice President of Finance
Blue Cross Blue Shield of Kansas City
One Pershing Square
2301 Main
Kansas City, MO 64108-2442

Dear Ms. Tromans:

This report provides the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review titled *Audit of the Pension Plan at a Terminated Medicare Contractor, Blue Cross Blue Shield of Kansas City*. The purpose of our review was to evaluate Blue Cross Blue Shield of Kansas City's (Kansas City) compliance with the pension segmentation requirements of its Medicare contract and to determine the excess assets that should be refunded to Medicare as a result of the termination of the Medicare contract.

Kansas City was the Medicare contractor for parts of the state of Missouri until the contract was terminated effective October 1, 1991. Under the terms of the contract, any difference between the Medicare segment pension assets and actuarial liability at the time the Medicare segment terminated should be refunded to the Medicare program.

We recommend that Kansas City refund $635,984 of excess Medicare pension assets resulting from the termination of their Medicare contract. Kansas City believed that elements of our calculations resulted in an overstatement of the recommended refund. Kansas City's response is included in its entirety as Appendix B. Appendix C contains the Health Care Financing Administration (HCFA), Office of Actuary's comments on Kansas City's response.

INTRODUCTION

BACKGROUND

Kansas City administered the Medicare program under cost reimbursement contracts since the start of the Medicare program. The contracts, the Federal Acquisition Regulations (FAR) (which superseded the Federal Procurement Regulations (FPR)) and the Cost Accounting Standards (CAS) contain reimbursement principles for cost reimbursement contracts.

Since its inception, Medicare 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.

The CAS 412 regulates the determination and measurement of the components of pension costs. It also regulates the assignment of pension costs to appropriate accounting periods. The CAS 413 regulates the valuation of pension assets, allocation of pension costs to segments of an organization, adjustment of pension costs for actuarial gains and losses, and assignment of gains and losses to cost accounting periods.

The HCFA incorporated segmentation requirements into Medicare contracts starting with Fiscal Year 1988. The contractual language specifies segmentation requirements and also provides for the separate identification of the pension assets for a Medicare segment.

Kansas City's contract required: (1) computing the Medicare segment's actuarial liability, (2) determining the ratio of the Medicare segment's actuarial liability to the total plan actuarial liability (asset fraction), (3) allocating a portion of total pension assets as of 1986 based on the above ratio, (4) updating Medicare pension assets annually, and (5) assessing if Medicare's pension costs should be separately calculated.

The Medicare contracts identify a Medicare segment as:

> "*... any organizational component of the contractor, such as a division, department, or other similar subdivision, having a significant degree of responsibility and accountability for the Medicare contract/agreement, in which:*
>
> 1. *A majority of the salary dollars is allocated to the Medicare agreement/contract, or*
>
> 2. *Less than a majority of the salary dollars is allocated to the Medicare agreement/contract, and these salary dollars represent 40 percent or more of the total salary dollars allocated to the Medicare agreement/contract.*"

The contracts also provided for separate identification of the pension assets of the Medicare segment. The identification involved the allocation of assets to the Medicare segment as of the first pension plan year after December 31, 1985 in which the salary criterion was met. The allocation used the ratio of the actuarial liabilities of the Medicare segment to the actuarial liabilities of the total plan, as of the later of: (1) the first day of the first plan year starting after December 31, 1980, or (2) the first day of the first pension plan year following the date such Medicare segment first existed.

The CAS 9904.413-50(c)(12), addresses contract terminations and provides criteria for closure of a segment. It states:

> *"If a segment is closed, the contractor shall determine the difference between the actuarial liability for the segment and the market value of the assets allocated to the segment, irrespective of whether or not the pension plan is terminated.... The calculation of the difference between the market value of the assets and the actuarial liability shall be made as of the date of the event that caused the closing of the segment."*

Kansas City participates in the National Retirement Program administered by the Blue Cross/Blue Shield National Employee Benefits Administration (NEBA). The Wyatt Company, NEBA's actuarial firm, played a major role in the preparation of Kansas City's questionnaire response.

SCOPE

We made our examination in accordance with generally accepted government auditing standards. Our objectives were to determine Kansas City's compliance with pension segmentation requirements of its Medicare contract, and to determine the amount of excess assets that should be refunded to Medicare as a result of the Medicare contract termination. Achieving our objectives did not require a review of Kansas City's internal control structure. The audit addressed Kansas City's initial determination of pension assets for its Medicare segment and later updates.

We reviewed Kansas City's identification of the Medicare segment as of January 1, 1988 and traced the segment's organizational lineage back to 1981. We also reviewed Kansas City's computation of the asset fraction and its update of Medicare assets from January 1, 1986 to January 1, 1988.

In performing our review, we used information provided by NEBA and NEBA's pension actuary. The information included liabilities, normal costs, contributions, benefit payments, expenses, and earnings. We reviewed Kansas City's accounting records, pension plan documents, annual actuarial valuation reports, and the Department of Labor/Internal Revenue Service Forms 5500. Using these documents, we calculated Medicare segment assets as of January 1, 1992. The HCFA Office of the Actuary reviewed our methodology and calculations.

We performed site work at Kansas City's corporate offices in Kansas City and in our Kansas City, Missouri office at various times during November 1997 through January 1998.

FINDINGS AND RECOMMENDATION

UNDERSTATED ASSET FRACTION

We determined that Kansas City understated its Medicare asset fraction by .38464 percent. In computing the asset fraction, Kansas City included actuarial liabilities for two employees who were not employed in Medicare cost centers and excluded actuarial liabilities for eight employees who were employed in Medicare cost centers. We increased the Medicare asset fraction from 6.06525 percent to 6.44979 percent by using the correct actuarial liability. Our calculations increased the Medicare segment assets by $53,801 to $874,997. The following schedule shows the details of our calculations.

Schedule of Audited and Kansas City Asset Fractions
And Resulting 1986 Medicare Asset Difference

Description	1981 Actuarial Liability		1981 Rounded Asset Fraction	1986 Assets	
	Total	Medicare		Total	Medicare
Audited	$9,496,841	$612,526	.0644979	$13,566,279	$874,997
Kansas City	9,496,841	576,007	.0606525 1/	13,566,279	821,196 1/
Difference	$ 0	$ 36,519	.0038464	$ 0	$ 53,801

1/ Although Kansas City's asset fraction was 6.06525 percent, Kansas City used an asset fraction of 6.05321 percent to establish Medicare assets as of January 1, 1986.

ASSETS OVERSTATED

Kansas City's methodology in updating the Medicare assets from January 1, 1986 to January 1, 1992 overstated the segment assets by $243,027. The overstatement resulted from making inaccurate transfer adjustments ($220,236 overstatement), calculating the updates with incorrect asset amounts ($27,399 overstatement), and using incorrect benefit payments to Medicare non-actives ($4,608 understatement) for 1989.

Participants and Transfers

Kansas City could not provide details to support assets transferred to and from the Medicare segment except for years 1990 and 1991. Consequently, we were unable to identify the differences between Kansas City and audited asset transfers for years other than 1990 and 1991. Kansas City correctly identified the Medicare segment organizational components and cost centers used to develop assets transferred to and from the Medicare segment for 1990 and 1991. However, Kansas City incorrectly identified plan participants in the organizational components and cost centers. Some individuals were considered non-segment participants and should have been considered segment participants. Some individuals were considered segment participants and should have been considered non-segment participants. Since the identification of the segment participants was incorrect, transfers (representing the movement into and out of the segment each year) in the updates were also incorrect. The following schedule compares the Kansas City and audited transfers by year.

Schedule of Transfer Adjustments For The Medicare Segment			
Years	Kansas City	Audited	Difference
1986	$ (87,174)	$ (87,174)	$ 0
1987	80,222	80,222	0
1988	53,893	53,893	0
1989	177,593	171,869	5,724
1990	145,156	(166,092)	311,248
1991	(593,715)	(496,979)	(96,736)
Totals	$(224,025)	$(444,261)	$220,236

We used the OIG transfer amounts in updating the Medicare segment assets (See Appendix A). Our computation resulted in a net decrease of $220,236 in the Medicare segment assets.

Allocating Earnings And Expenses

Kansas City's update methodology allocated investment earnings and administrative expenses to the Medicare segment based on a ratio of segment assets to total company assets. Because Kansas City started the update with an understated 1986 asset base (See Medicare Asset Fraction above), it understated the segment's earnings and expenses for 1986 and 1987. In 1988 through 1991, incorrect transfer adjustments resulted in overstating the asset bases for those years. This resulted in an overall overstatement of assets for the period 1986 through 1991. Except for using our adjusted asset bases for the asset fraction and transfer errors, we used Kansas City's allocation methodology in our update and decreased the Medicare segment assets by $27,399.

Benefit Payments

Kansas City's computations included benefit payments of $116,435 for calendar year 1989. We identified the benefits paid to Medicare non-actives in 1989 of only $111,827 and included these payments in our update of the segment's assets. Our correction to the benefit payments increased the Medicare assets by $4,608 ($116,435 less $111,827).

Medicare Assets as of January 1, 1992

We updated pension assets of the Medicare segment from January 1, 1986 to January 1, 1992 (See Appendix A). Our calculation showed that the assets of the Medicare segment as of January 1, 1992 were $1,238,337 instead of $1,427,563 proposed by Kansas City. This decrease ($189,226) resulted from revising the asset fraction ($53,801 increase), correcting the transfer adjustments ($220,236 decrease), calculating the update with corrected asset amounts ($27,399 decrease), and correcting benefit payments to Medicare non-actives ($4,608 increase) for 1989.

EXCESS MEDICARE PENSION ASSETS

Medicare contracts specifically prohibit any profit (gain) from Medicare activities. Therefore, according to the contract, pension gains which occur when a Medicare segment terminates should be credited to the Medicare program. In addition, FAR addresses dispositions of gains in situations such as contract terminations. When excess or surplus assets revert to a contractor as a result of termination of a defined benefit pension plan, or such assets are constructively received by it for any reason, the contractor shall make a refund or give credit to the Government for its equitable share (FAR, section 31.205-6(j)(4)).

Kansas City's Medicare contract was terminated effective October 1, 1991. Around that time the Medicare pension plan participants transferred to the commercial side or terminated their employment. The market value of Medicare pension assets as of January 1, 1992 was $1,238,337 with actuarial liabilities of $602,353. Consequently, the excess Medicare assets totaled $635,984 at the time the contract was terminated.

Recommendation:

We recommend that Kansas City:

> Refund $635,984 of excess Medicare pension assets resulting from termination of its Medicare contract.

Auditee Response

Kansas City's comments are summarized in the following paragraphs and presented in detail on Appendix B.

Kansas City believed that our audit report: (1) failed to recognize that the amount of any pension cost adjustment is severely constrained by "Closing Agreements" and the effective date of CAS 413; (2) underestimated the actuarial liabilities attributable to the Medicare segment; and (3) misstated the amount of the pension assets attributable to the Medicare segment. Additionally, Kansas City believed that our segment closing calculations should have considered HCFA's responsibility for the portion of the unfunded post-retirement benefits (PRB) liability that is attributable to Kansas City's Medicare contracts.

According to Kansas City, the amount of any pension cost adjustment is severely constrained by the closing agreements and the effective date of CAS 413. They assert that the CAS 413 and binding closing agreements limit any adjustment under CAS 413.50(c)(12) to the amount of the Medicare segment's reimbursed pension costs that are not covered by a "Closing Agreement." And, any pension cost adjustment under CAS 413.50(c)(12) may not exceed the Medicare segment's pension costs that were actually reimbursed by HCFA after CAS 413 first became applicable to the Medicare contracts.

Kansas City also believes that our report underestimates the amount of the actuarial liabilities attributable to the Medicare segment. Kansas City maintains that a projected benefit measure of liability should be used for those active Medicare employees who transferred to the non-Medicare segment following the termination of the segment. Furthermore, Kansas City asserts that all of the actuarial liabilities should be valued using a discount rate that reflects market conditions as of the date of the segment closing, and that the actuarial liability should reflect the present value of the future administrative expenses.

According to Kansas City, our report may have misstated the amount of the pension assets attributable to the Medicare segment. Kansas City questioned whether our asset transfer methodologies were consistent with the requirements of CAS 413, and were appropriate for use in a segment closing calculation.

Finally, Kansas City contends that our report should have considered HCFA's responsibility for the portion of Kansas City's unfunded PRB liability that is attributable to its Medicare contracts. Kansas City requests that our report reduce any recommended pension cost remittance by the amount of the unfunded PRB liability that is attributable to Kansas City's Medicare employees.

OIG Comments

Our comments are summarized in the following paragraphs. The HCFA, Office of the Actuary's detailed comments on Kansas City's response are presented on Appendix C.

Kansas City's arguments ignore the terms and underlying principles of their Medicare contracts. The Medicare contracts required that the calculation of and accounting for pension costs be governed by the FAR, and CAS 412 and 413. The HCFA incorporated segmentation requirements into Medicare contracts starting with Fiscal Year 1988. Additionally, the contracts defined a Medicare segment, and specified the methodology for the identification and initial allocation of pension assets to the Medicare segment.

The contracts' methodology for establishing the initial Medicare segment assets was negotiated and agreed to by HCFA and the Medicare contractors, the objective of the methodology was to fairly represent the events of prior periods. Therefore, any over or under funding of the pension plan in prior years was captured in the initial allocation of the segment's pension assets, regardless of the status of any closing agreements for those prior years.

The contracts also required that the Medicare segment assets be updated for each year after the initial allocation in accordance with CAS 413. The segment's pension assets were to be increased by contributions and earnings, and decreased by plan expenses and benefit payments in the same manner as the total pension plan.

Kansas City implemented the Medicare contract provisions by identifying a Medicare segment, establishing the segment's initial pension assets as of January 1, 1986 , and updating the segment's pension assets from 1986 through 1991.

According to CAS 413, when a segment is closed, the contractor must determine the difference between the actuarial liability for the segment and the market value of the assets allocated to the segment. That comparison of the segment's market value of assets and actuarial liability is to be made as of the date of the event that caused the closing of the segment, such as a contract termination. Therefore, the computation is made as of a single point in time irrespective of what has transpired previously. If the segment's market value of assets exceeds the actuarial liability at that point in time, then a gain has occurred.

The Medicare contracts specifically prohibit any profit (gain) from Medicare activities. Therefore, according to the contract, pension gains which occur when a Medicare segment terminates should be credited to the Medicare program. Additionally, the FAR addresses dispositions of gains in situations such as contract terminations. According to the FAR, when excess or surplus assets revert to a contractor as a result of termination of a defined benefit pension plan, or such assets are constructively received by it for any reason (such as a segment closing), the contractor should make a refund to the Government for its equitable share.

We find no provisions in Kansas City's Medicare contracts, the CAS, or the FAR to support Kansas City's assertion that "the amount of any pension cost adjustment is severely constrained by the closing agreements and the effective date of CAS 413."

Kansas City asserts that our report underestimates the amount of the actuarial liabilities attributable to the Medicare segment. According to Kansas City, we should have used a projected measure of liability for active employees, and should have used a discount rate that reflects the market conditions as of the date of the segment closing to value those liabilities. Additionally, Kansas City believes that the actuarial liability of the Medicare segment should have reflected the present value of future administrative expenses.

We do not agree with the use of a projected measure of actuarial liability for the purposes of calculating a segment closing adjustment. The projected benefit method is allowable when there is a future causal/beneficial relationship. An underlying principle of the CAS and Government contract accounting in general, has been that there must be a causal/beneficial relationship between incurring a cost and the performance of a contract before that cost can be allocated to and allowed under that contract.

When a segment closes, there is an end to the causal/beneficial relationship between future pay raises and the Government contracts. Thus it is inappropriate to recognize future salary increases when determining the 413.50(c)(12) segment closing adjustment.

The actuarial liability used to determine the CAS 413.50(c)(12) adjustment was provided by Kansas City's actuary, and it was based on the interest and mortality valuation assumptions used since 1988. We found no evidence that Kansas City or its actuary believed its valuation assumptions were unreasonable. Additionally, the actuarial liability provided by Kansas City's actuary did include assumptions and methods to provide for administrative expenses. We made no adjustments to remove or change the recognition of administrative expenses.

Kansas City asserts that our report may have misstated the pension assets attributable to the Medicare segment, due to the asset transfer methodologies used. However, Kansas City did not provide any reasons why they believed that the asset transfer methodologies were inappropriate. Our update methodologies were the same as those that were historically, and consistently, used by Kansas City, and/or their consulting actuary. In fact, the update methodologies used by Kansas City are the same methodologies that we have found, and generally accepted, during audits of seventeen other Medicare contractors that employed the same consulting actuary.

Kansas City requests that we offset the excess Medicare pension assets by the amount of the unfunded PRB liability that is attributable to Kansas City's Medicare employees. However, to date, Kansas City has not submitted a claim for Medicare reimbursement for any such PRB liability. Accordingly, a review of any such PRB liability was not included in the scope of our audit.

INSTRUCTIONS FOR AUDITEE RESPONSE

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

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

Sincerely,

Barbara A. Bennett

Barbara A. Bennett
Regional Inspector General for
Audit Services, Region VII

Enclosures

HHS Action Official

Mr. Joe L. Tilghman
Regional Administrator, Region VII
Health Care Financing Administration
601 E. 12th Street, Room 235
Kansas City, Missouri 64106

BLUE CROSS BLUE SHIELD OF KANSAS CITY
STATEMENT OF MEDICARE PENSION ASSETS

FOR THE PERIOD
JANUARY 1, 1986 THROUGH JANUARY 1, 1992

Description	Total Company	Other Segment	Medicare	Footnotes
Assets January 1, 1986	$13,566,279	$12,691,282	$ 874,997	1/
Contributions	166,428	140,769	25,659	2/
Prepayment	0	0	0	
Earnings	2,146,199	2,007,774	138,425	3/
Benefits	(394,631)	(394,631)	0	4/
Expenses	(83,475)	(78,091)	(5,384)	5/
Transfers	0	87,174	(87,174)	6/
Assets January 1, 1987	$15,400,800	$14,454,277	$ 946,523	
Contributions	429,749	391,179	38,570	
Prepayment	0	0	0	
Earnings	698,410	655,486	42,924	
Benefits	(400,939)	(400,939)	0	
Expenses	(99,260)	(93,160)	(6,100)	
Transfers	0	(80,222)	80,222	
Assets January 1, 1988	$16,028,760	$14,926,621	$1,102,139	
Contributions	0	0	0	
Prepayment	0	0	0	
Earnings	2,204,688	2,053,093	151,595	
Benefits	(285,070)	(285,070)	0	
Expenses	(104,941)	(97,725)	(7,216)	
Transfers	0	(53,893)	53,893	
Assets January 1, 1989	$17,843,437	$16,543,026	$1,300,411	
Contributions	0	0	0	
Prepayment	0	0	0	
Earnings	4,023,047	3,729,851	293,196	
Benefits	(840,462)	(718,634)	(111,828)	
Expenses	(120,019)	(111,272)	(8,747)	
Transfers	0	(171,869)	171,869	
Assets January 1, 1990	$20,916,003	$19,271,102	$1,644,901	

BLUE CROSS BLUE SHIELD OF KANSAS CITY
STATEMENT OF MEDICARE PENSION ASSETS

FOR THE PERIOD
JANUARY 1, 1986 THROUGH JANUARY 1, 1992

Description	Total Company	Other Segment	Medicare	Footnotes
Assets January 1, 1990	$20,916,003	$19,271,102	$1,644,901	
Contributions	0	0	0	
Prepayment	0	0	0	
Earnings	(516,100)	(475,512)	(40,588)	
Benefits	(789,896)	(789,896)	0	
Expenses	(115,544)	(106,457)	(9,087)	
Transfers	0	166,092	(166,092)	
Assets January 1, 1991	$19,494,463	$18,065,329	$1,429,134	
Contributions	0	0	0	
Prepayment	0	0	0	
Earnings	4,284,973	3,970,842	314,131	
Benefits	(630,658)	(630,658)	0	
Expenses	(108,427)	(100,748)	(7,949)	
Transfers	0	496,979	(496,979)	
Assets January 1, 1992	$23,040,351	$21,802,014	$1,238,337	
Assets Per Blue Cross Blue Shield	$23,040,351	$21,612,788	$1,427,563	7/
Asset Variance	$0	$189,226	($189,226)	8/

1/ We calculated the Medicare segment assets based on our identification of the Medicare segment and our computed asset fraction (6.44979%). We computed the asset fraction as explained in our finding section of the report narrative.

2/ We obtained total contribution amounts from IRS Form 5500 reports. We allocated the contributions to the Medicare segment based on the ratio of segment participants' normal costs and accrued liability to total company normal costs and accrued liability. Kansas City used this same methodology. Kansas City did not make contributions to the pension trust fund for years 1988 through 1991.

3/ Kansas City provided earning amounts and we verified them to IRS Form 5500 reports. We allocated earnings to the Medicare segment based on the ratio of beginning of year market value of Medicare assets to beginning of year market value of total assets. Kansas City used this same methodology.

4/ Kansas City provided benefit payment amounts and we verified them to IRS Form 5500 reports. We used actual benefit payments for Medicare segment retirees.

5/ Kansas City provided administrative expense amounts and we verified them to IRS Form 5500 reports. We allocated administrative expenses to the Medicare segment on the ratio of beginning of year market value of Medicare assets to beginning of year market value of total assets. Kansas City used this same methodology.

6/ We identified participant transfers between segments by analyzing employee movement into and out of cost centers that were identified by us (and agreed upon by Kansas City) as Medicare cost centers. We used electronic data files provided by Kansas City that contained the actuarial liability of each participant.

7/ We obtained the total assets as of January 1, 1992 from Kansas City's update of assets provided by its actuary.

8/ The asset variance represents the difference between the OIG calculation of assets as of January 1, 1992 and the assets calculated by Kansas City's actuary.

Blue Cross
Blue Shield
of Kansas City

May 29, 1998 Via Courier

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

RE: Comments of Blue Cross Blue Shield of Kansas City
Concerning Draft Audit Report No. CIN A-07-97-02503

Dear Ms. Bennett:

Thank you for affording Blue Cross Blue Shield of Kansas City ("BCBSKC") this opportunity to comment on draft Audit Report No. CIN A-07-97-02503 ("the draft audit report"), and for extending the due date for the submission of our comments. We appreciate the cooperation rendered to us by your auditors.

The draft audit report recommends that BCBSKC remit $635,984 to the Federal government. According to the report, that amount is said to represent excess Medicare pension assets as of January 1, 1992, which purportedly arose from pension cost reimbursements made by the Health Care Financing Administration ("HCFA") under BCBSKC's Medicare contracts. The draft audit report contends that HCFA is entitled to the recommended remittance by Cost Accounting Standard ("CAS") 413.50(c)(12), which provides for an "adjustment of previously-determined pension costs" upon the closure of a segment, and by Federal Acquisition Regulation ("FAR") 31.205-6(j)(4).

We have carefully reviewed the draft audit report. Based upon our review to date, and as explained in detail below, we believe that the draft audit report is marred by the following flaws: (1) the report fails to recognize that the amount of any pension cost adjustment is severely constrained by "Closing Agreements" and the effective date of CAS 413; and (2) it underestimates the actuarial liabilities attributable to the Medicare segment. We may identify additional flaws or modify our analysis as our review progresses. Because these flaws caused the recommended remittance to be overstated, we request that the amount of the recommended remittance, if any, be recalculated in light of the comments set forth below.

One Pershing Square • 2301 Main • P.O. Box 419169 • Kansas City, MO • 64141-6169 • 816/395-2222

Ms. Barbara A. Bennett
May 29, 1998
Page 2

In addition, the draft audit report does not consider HCFA's responsibility for the accrued costs of the post-retirement benefits ("PRBs") earned to date by BCBSKC's Medicare employees and for which HCFA has not yet reimbursed BCBSKC. Although we have not yet precisely quantified the amount for which HCFA is responsible, we believe that this amount will equal or exceed the amount of the recommended pension remittance. We request that your final audit report reduce any recommended pension cost remittance by the amount of the unfunded PRB liability that is attributable to BCBSKC's Medicare employees.

We would be pleased to discuss the draft audit report, our comments, and our suggested recalculations with you or your staff prior to the issuance of your final audit report.

I. THE DRAFT REPORT DOES NOT RECOGNIZE THAT ANY PENSION COST ADJUSTMENT IS CONSTRAINED BY CLOSING AGREEMENTS AND THE EFFECTIVE DATE OF CAS 413.

We believe that the $635,984 remittance recommended by the draft audit report is overstated, even assuming that the amounts of pension assets and actuarial liabilities attributable to the Medicare segment were correctly determined. This is so because the report fails to recognize that: (1) a negative "adjustment of previously-determined costs" under CAS 413.50(c)(12) may not exceed the amount of the Medicare segment's pension costs that were actually reimbursed by HCFA for fiscal years where the allowable pension costs were not finally determined by a "Closing Agreement"; and (2) any such adjustment may not exceed the amount of the Medicare segment pension costs that were actually reimbursed by HCFA for the fiscal years after CAS 413 first became applicable to the Medicare contracts.

A. CAS 413 And Binding Closing Agreements Limit Any Adjustment Under CAS 413.50(c)(12) To The Amount Of The Medicare Segment's Reimbursed Pension Costs That Are Not Covered By A "Closing Agreement."

The draft audit report contends that BCBSKC had "excess Medicare pension assets" of $635,984 as of January 1, 1992, and recommends that BCBSKC remit that amount to the Federal government under the authority of CAS 413.50(c)(12). However, the report fails to recognize that CAS 413.50(c)(12) does *not* entitle the government to a portion of any excess pension assets held in BCBSKC's pension plan upon the closure of a segment.[1/] Instead, that provision provides

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1/ The revisions to CAS 412, CAS 413 and, in particular, to CAS 413.50(c)(12), that were promulgated on March 30, 1995, are inapplicable here. Under its effective date provision, that revision applies only to contractors who received a new contract after March 30, 1995. BCBSKC
(Footnote continued on next page)

simply for an "adjustment of previously-determined pension costs" -- the pension costs reimbursed by HCFA under Medicare contracts in prior years -- when a segment closes. *See* CAS 413.50(c)(12).

This distinction between a right to excess assets and a right to a cost adjustment is crucial. The amount of a negative "adjustment of previously-determined pension costs" under CAS 413.50(c)(12) cannot exceed the total amount of the pension costs that are being "adjusted," that is, the pension costs of the Medicare segment that were previously reimbursed by HCFA. A demand for the remittance of excess pension assets in an amount that exceeds the total amount of the segment's pension costs that were reimbursed by HCFA cannot meaningfully be said to be an "adjustment" of those reimbursed costs.

Moreover, the report fails to recognize that many of the Medicare segment's pension costs that were reimbursed by HCFA to BCBSKC for prior years are covered by "Closing Agreements" executed by HCFA. By their own terms and as required by BCBSKC's Medicare contracts, each of these "Closing Agreements" constitutes a "final determination" of the amount of allowable costs chargeable to Medicare for the period covered by the Agreement. Costs covered by such a "Closing Agreement" are therefore not subject to subsequent adjustment by the government. *See, e.g., Continental Aviation & Engineering Corp.*, ASBCA Nos. 9894 & 9938, 65-1 BCA ¶ 4660 at 22,289-90; *see also Blue Cross & Blue Shield Ass'n v. United States*, 13 Cl. Ct. 710, 715 (1987), *aff'd without op.*, 852 F.2d 1294 (Fed. Cir.), *cert. denied*, 488 U.S. 993 (1988); *Blue Cross Ass'n & Blue Cross of Virginia*, ASBCA No. 25776, 81-2 BCA ¶ 15,359 at 76,079, 76,083-84. Indeed, HCFA's practice of excluding pension costs incurred after fiscal year 1987 from the finality of its Medicare "Closing Agreements" confirms that pension costs are among the costs normally covered by such agreements; if pension costs were not covered by "Closing Agreements," there would have been no need explicitly to exclude them from the operation of such agreements.

Accordingly, the only pension costs that may be adjusted pursuant to CAS 413.50(c)(12) are those reimbursed pension costs of the Medicare segment that are not covered by a "Closing Agreement" executed by HCFA, and the amount of any such adjustment is limited to the total Medicare segment pension cost reimbursement for periods in which pension costs are not covered by a "Closing Agreement." Thus, we request that you reduce the amount of your recommended pension remittance so that it does not exceed the total Medicare segment pension cost reimbursement for periods not covered by a "Closing Agreement."

(Footnote continued from previous page)
did not receive a new Medicare contract after that date. Accordingly, all references in this letter to CAS 412 and 413 are to the pre-revision versions of those standards.

Ms. Barbara A. Bennett
May 29, 1998
Page 4

B. Any Pension Cost Adjustment Under CAS 413.50(c)(12) May Not Exceed The Medicare Segment's Pension Costs That Were Actually Reimbursed By HCFA After CAS 413 First Became Applicable To The Medicare Contracts.

Any adjustment of the previously determined pension costs of BCBSKC under CAS 413.50(c)(12) may not exceed the amount of the Medicare segment's pension costs that were reimbursed by HCFA after fiscal year 1980, even assuming that no "Closing Agreement" limits the amount of that adjustment. This is so because CAS 413, the only procurement regulation purporting to provide for a "segment closing" adjustment,[2/] did not become applicable to the Medicare contracts of BCBSKC until the fiscal year beginning October 1, 1980. CAS 413.50(c)(12) cannot provide the basis for adjusting costs that were incurred on prior Medicare contracts because CAS 413 never applied to those costs or contracts; only pension costs incurred after CAS 413 became applicable to Medicare are subject to adjustment.

It is a basic axiom of government procurement law that only those procurement regulations that are incorporated in a contract on its effective date may be applied to the contract. Subsequently promulgated or revised regulations cannot be applied to contracts already in existence on the date of the promulgation or revision. This axiom is well established in the case law. For example, a number of cases have considered the impact of a change in the cost principles -- the regulations governing the costs that can be reimbursed under government contracts -- under two contracts, one of which was entered into prior to the effective date of the change and the other of which was entered into after that effective date. These cases have consistently held that the cost principle change may be applied to the contract entered into after the effective date of the change but may not be applied to the contract entered into prior to that effective date. *See, e.g., Dynalectron Corp.*, ASBCA No. 20240, 77-2 BCA ¶ 12,835; *The Boeing Co.*, ASBCA No. 11866, 69-2 BCA ¶ 7898, *aff'd on reconsid.*, 70-1 BCA ¶ 8298, *aff'd*, 480 F.2d 854, 863 (Ct. Cl. 1973). Other cases have refused to apply a new or revised cost principle to contracts that were entered into prior to the effective date of the new or revised cost principles. *See, e.g., Lockheed Aircraft Co. v. United States*, 426 F.2d 322, 327-28 (Ct. Cl. 1970); *Lockheed-Georgia Co., A Division of Lockheed Corp.*, ASBCA No. 27760, 90-3 BCA ¶ 22,957.

2/ FAR 31.205-6(j)(4), referred to in the draft audit report, does not entitle the government to receive a share of BCBSKC's pension assets. That provision applies only when a contractor receives excess pension assets, such as by terminating a pension plan. Here, BCBSKC has not terminated its pension plan and will neither actually nor constructively receive any surplus pension assets. Thus, FAR 31.205-6(j)(4) is simply inapplicable.

Ms. Barbara A. Bennett
May 29, 1998
Page 5

Thus, only the pension costs of the Medicare segment that were actually reimbursed by HCFA for the fiscal years after CAS 413 first became applicable to the Medicare contracts of BCBSKC may be adjusted under the authority of CAS 413.50(c)(12), and any such adjustment may not exceed the amount of the Medicare segment's pension costs that were reimbursed by HCFA for periods after that date. Thus, we request that you reduce the amount of your recommended pension remittance so that it does not exceed the total Medicare segment pension cost reimbursement for periods in which BCBSKC's Medicare contract was subject to the CAS.

II. THE REPORT UNDERSTATES THE AMOUNT OF THE ACTUARIAL LIABILITIES ATTRIBUTABLE TO THE MEDICARE SEGMENT.

Upon the closure of a segment, CAS 413.50(c)(12) provides for an "adjustment of previously-determined pension costs," measured by the "difference between the market value of assets and the actuarial liability for the segment." As the audit report apparently recognizes, there will remain in BCBSKC's Medicare segment upon the termination of BCBSKC's involvement in the Medicare program a significant amount of actuarial liabilities. The difference between these liabilities, properly identified and properly valued, and the market value of the segment's pension assets represents the "adjustment of previously-determined pension costs" contemplated by CAS 413.50(c)(12).

The segment closing adjustment set forth in the draft audit report should be recalculated to reflect properly the actuarial liabilities of the Medicare segment. The amount of those actuarial liabilities should be determined as follows: (1) a projected benefit measure of liability should be used for those active employees who should be considered within the segment or who transferred from the Medicare segment; (2) all of the actuarial liabilities should be valued using a discount rate that reflects market conditions for the month during which the segment closed; and (3) the actuarial liability for the Medicare segment should reflect the present value of future administrative expenses.

A. A Projected Benefit Measure Of Liability Should Be Used For Those Active Medicare Employees Within The Segment Or Who Transferred To The Non-Medicare Segment.

Consistent with the requirements of CAS 412.50(b)(1) & (2), BCBSKC utilized a projected benefit cost method to determine its annual pension costs. Under that method, the pension cost attributable to the current year properly reflects the actuarial assumption that certain of the contractor's employees will receive salary increases in future years. In contrast, the accrued benefit cost method used in the draft audit report is based solely on the pension benefits accrued to date by a pension plan participant, and does not consider the assumed escalation in salaries that was integral to the contractor's CAS 412-compliant pension cost method.

For those employees within the Medicare segment or who transferred to the non-Medicare segment, the projected benefit cost method is the only appropriate method of valuing actuarial liability for purposes of CAS 413.50(c)(12). Those employees remained with BCBSKC and received or will receive salary increases. Under the contractor's CAS 412-compliant pension cost method, the pension cost associated with those salary increases was properly reflected in the pension costs incurred prior to the termination of the Medicare contracts. In contrast, the use of an accrued benefit cost method would understate the actuarial liabilities associated with employees who remain with BCBSKC because it would omit from the calculation of the Medicare segment's actuarial liability a portion of the actuarial liability generated in prior years by an employee's Medicare service.

In fact, CAS 413's segment closing provision requires the use of a projected benefit cost method in valuing a segment's actuarial liabilities where, as here, the contractors used that method for purposes of determining pension costs under CAS 412. That is so because the segment closing adjustment under CAS 413.50(c)(12) is calculated as the "difference between the market value of assets and the *actuarial liability* for the segment," and "actuarial liability" is defined by CAS 413.50(a)(4) in part as the "pension cost attributable, *under the actuarial method in use*, to years prior to the date of a particular actuarial valuation." (Emphases added). The projected benefit method must be used to value the actuarial liabilities of those employees within the Medicare segment or who transferred to the non-Medicare segment.

B. The Actuarial Liabilities Should Be Valued Using A Discount Rate That Reflects Market Conditions As Of The Date Of The Segment Closing.

The actuarial liabilities of the Medicare segment should be valued using a discount rate that reflects market conditions during the month for which the segment closing calculation is being made. This is necessary in order to be consistent with the requirement of CAS 413.50(c)(12) that the segment's assets be valued at market.

CAS 413.50(c)(12) requires a comparison between the value of a closed segment's pension assets and the value of its actuarial liabilities. For this calculation, CAS 413.50(c)(12) specifically requires that the closed segment's pension assets be valued at market as of the date of segment closure. Consistency requires that the closed segment's actuarial liabilities also be valued using an interest rate, such as the PBGC rate, that is consistent with market conditions at the time of segment closure.

A valuation of the Medicare segment's pension assets in a manner that reflects the interest rate environment prevailing at the time the segment closed, while valuing its actuarial liabilities using the pension plan's higher interest rate assumption, would result in a meaningless comparison of "apples and oranges." As explained below, such a comparison would understate the Medicare segment's actuarial liabilities relative to the value of its pension assets and would overstate the amount of any remittance owed the government under CAS 413.50(c)(12).

For ongoing pension funding purposes, BCBSKC valued its pension assets and liabilities using actuarial methods that smoothed the effects of short-term fluctuations in market value and market interest rates. For example, in accordance with CAS 412.50(b)(5) and CAS 413.40(b), it determined the value of pension assets using an actuarial method that smoothed fluctuations in market value and yielded actuarial values that differed significantly from market values. The market values of many pension assets, such as corporate bonds, are sensitive to interest rate fluctuations. The market values of such assets will generally be higher than their actuarial values when the market interest rate is lower than the actuarially smoothed interest rate assumption. At the time of the segment closure, the prevailing interest rates were lower than the actuarially smoothed interest rate used by the pension plans.

Similarly, in accordance with CAS 412.50(b)(5), BCBSKC utilized a discount rate for valuing actuarial liabilities that smoothed the effect that short-term fluctuations in interest rates have on those actuarial liabilities. A reduction in the discount rate used to calculate the present value of an actuarial liability will increase that present value, while an increase in the discount rate will reduce it. Thus, the present value of the actuarial liability calculated using the actuarially smoothed interest rate would have been significantly less than the present value calculated using the lower market interest rate that was prevailing at the time the segment purportedly closed.

CAS 413.50(c)(12) does not, however, permit the use of an actuarially smoothed asset value in calculating the adjustment of previously determined pension costs. Instead, it specifically requires that "the market value of assets allocated to the segment" be determined "as of the date of the event . . . that caused the closing of the segment." The difference between actuarial asset value and market asset value in part reflects that interest rate environment prevailing on the date of the market valuation. For example, a corporate bond held by a pension plan that was issued with a yield of 8.50% will increase in market value if the market interest rate decreases to 7.25%, but that increase in market value will not be fully reflected by a valuation method that "smoothes" short-term fluctuations in asset value. In contrast, the fair market value of pension assets on a particular day fully reflects the interest rate and yield expectations of the marketplace on that date.

In order for a CAS 413.50(c)(12) calculation to be meaningful, the measure of a closed segment's actuarial liability should also reflect the interest rate and yield expectations of the marketplace on the date of the event that caused the segment closing. If not, the actuarial liability will be valued in a manner that is inconsistent with the required fair-market valuation of the closed segment's pension assets.

That inconsistency would significantly distort the calculation of the adjustment of previously determined pension costs for the Medicare segment. Valuing the actuarial liabilities using the pension plan's interest rate assumption, while valuing the pension assets in a manner that reflects the lower interest rates prevailing upon closure of the Medicare segment, would result in an understatement of the segment's actuarial liabilities relative to the value of its pension assets. Valuing its pension assets at market would increase the value of those assets, relative to their actuarial value, because that market value reflects the increase in value caused by a reduced interest rate environment. In contrast, valuing the segment's actuarial liabilities using the pension plan's ongoing interest rate would not fully recognize the increase in the present value of the actuarial liabilities that result from a reduced interest rate environment. Thus, the use of the plan's ongoing interest rate to value the Medicare segment's actuarial liabilities for purposes of the CAS 413.50(c)(12) adjustment would result in an overstatement of the recommended amount of any "adjustment of previously-determined pension costs" that may be due the government as a result of any closure of the Medicare segment.

C. The Calculation Of The Actuarial Liability Of The Medicare Segment Should Consider The Present Value Of Future Administrative Expenses.

The actuarial liability of the Medicare segment should also consider the present value of the future pension plan administrative expenses relating to the employees in the Medicare segment. That is so because the segment closing adjustment under CAS 413.50(c)(12) is calculated as the "difference between the market value of assets and the *actuarial liability* for the segment," and "actuarial liability" is defined by CAS 413.50(a)(4) in part as the "excess of the *present value of the future benefits and administrative expenses* over the present value of future contributions for the normal cost for all plan participants and beneficiaries." (Emphases added).

III. THE REPORT MAY MISSTATE THE AMOUNT OF THE PENSION ASSETS ATTRIBUTABLE TO THE MEDICARE SEGMENT.

Upon the closure of a segment, CAS 413.50(c)(12) provides for an "adjustment of previously-determined pension costs," measured by the "difference between the market value of assets and the actuarial liability for the segment." Here, the draft audit report may overstate the amount of any such adjustment by overstating the amount of pension assets attributable to the Medicare segment at the time it purportedly closed. We are continuing to review the asset transfer methodologies utilized by the auditors -- some of which were used by BCBSKC's actuaries -- to assess whether those methodologies are consistent with the requirements of CAS 413 and are appropriate for use in the context of a segment closing calculation. We will inform you or your auditors in the event we determine that further changes to their methodologies are required or are appropriate.

IV. THE REPORT SHOULD CONSIDER HCFA'S RESPONSIBILITY FOR THE PORTION OF BCBSKC'S UNFUNDED PRB LIABILITY THAT IS ATTRIBUTABLE TO ITS MEDICARE CONTRACTS.

The "segment closing" calculations set forth in the draft audit report were limited to pension costs, and failed to consider the funding status of BCBSKC's other PRB programs, such as its post-retirement health benefits program for retirees. BCBSKC's financial accounting records reflect significant liabilities under Statement of Financial Accounting Standards ("FAS") No. 106 for its PRB programs. Because BCBSKC's PRB programs are currently funded on a pay-as-you-go basis, there are no dedicated assets offsetting this PRB liabilities. Indeed, Medicare has made no reimbursement to BCBSKC for its future PRB costs and the PRB liabilities associated with BCBSKC's Medicare employees are therefore unfunded.

The "segment closing" calculation to be set forth in any final audit report should reflect Medicare's share of BCBSKC's unfunded PRB liabilities. BCBSKC's Medicare contracts specifically provide that the contractor "shall be paid its cost of administration under the principle of neither profit nor loss." However, if Medicare does not bear its share of BCBSKC's unfunded PRB liabilities, BCBSKC will be forced to bear a significant loss. We therefore request that your final audit report reduce any recommended pension cost remittance by the amount of the unfunded PRB liability that is attributable to BCBSKC's Medicare employees.

* * *

The information provided to the government by or on behalf of BCBSKC, either in this response or in connection with the audit giving rise to the draft audit report, is hereby designated as exempt from disclosure under Exemption (b)(4) of the Freedom of Information Act ("FOIA"), 5 U.S.C. § 552(b)(4), to the extent that such information is customarily not disclosed to the public by BCBSKC. In addition, disclosure of such information by the government would violate the Trade Secrets Act, 18 U.S.C. § 1905. Pursuant to 45 C.F.R. § 5.65(d), BCBSKC hereby requests that it be notified prior to any disclosure of this information (whether in response to a FOIA request, in a website posting, or otherwise) and be given the opportunity to submit prior written objections to such disclosure.

Thank you again for affording BCBSKC this opportunity to comment on draft Audit Report No. CIN A-07-97-02503. We believe that the resolution of the issues raised by that draft report can best be achieved through an open dialogue between the government and BCBSKC. To that end and because many of the issues raised are technical and complex, we would be pleased to discuss the draft audit report, our comments, and our suggested recalculations with you or your staff prior to the issuance of your final report. It may be particularly useful to discuss those issues relating to BCBSKC's PRB liabilities.

Sincerely,

Marilyn Tromans

Marilyn Tromans
Vice President of Finance

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MEMORANDUM

June 23, 1998

To: Barbara A. Bennett
Regional Inspector General for Audit Services, Region VII

From: Eric H. Shipley
Office of the Actuary

Eric H Shipley

Subject: Blue Cross Blue Shield of Kansas City Response to Draft Audit Reports on Pension Costs Charged to the Medicare Program and the Segment Closing Adjustment under CAS 413-50(c)(12)

In a letter dated May 24, 1998, Blue Cross Blue Shield of Kansas City (Kansas City) has objected to the dollar finding in the audit report on the closing of their Medicare Segment, CIN A-07-97-02503. Their letter raises seven specific issues regarding the segment closing finding which are summarized below in the order in which they were presented:

1. The pension cost adjustment is constrained to only pension costs reimbursed during periods not covered by closing agreements.

2. The pension cost adjustment is constrained to only pension costs reimbursed since CAS 413 first became applicable to the Medicare contracts.

3. A projected benefit measure of liability should be used for those active Medicare employees within the Medicare segment or who transferred to the non-Medicare segment.

4. The actuarial liabilities should be valued using a discount rate that reflects market conditions as of the date of the segment closing.

5. The calculation of the actuarial liabilities of the Medicare Segment should consider the present value of administrative expenses.

6. The amount of the segment's pension assets may be misstated due to the asset transfer methodology.

7. The report should consider HCFA's responsibility for the portion of unfunded post-retirement benefit liability that is attributable to its Medicare contracts.

My analysis is based upon Cost Accounting Standards (CAS) 412 and 413 that were in effect at the time of Kansas City's segment closing.[1] Because of the multitude and complexity of pension issues, the original Cost Accounting Standards Board (CASB) developed the accounting standards for pension costs in two stages. The CASB first addressed basic measurement and period assignment issues in CAS 412. In CAS 413, the CASB addressed how pension costs, which were measured under CAS 412, were to be adjusted for gains and losses and were to be allocated to segments. Consequently, these two standards must be taken together for any analysis to properly reflect the intent of the original Board. Moreover, when the current CAS Board amended CAS 412 and 413, the two standards were consistently treated as a unit in the Staff Discussion Paper, the Advance Notice of Proposed Rule Making, the Notice of Proposed Rule Making, and the Final Rule.

1. The pension cost adjustment is constrained to only pension costs reimbursed during periods not covered by closing agreements.

I disagree.

a) <u>The FAR 31.201-5 "Credits Clause" gives the Government entitlement to its share of the adjustment computed under CAS 413-50(c)(12).</u>

When Kansas City's segment closed, the "credits clause" found at FAR 31.201-5[2] provides the Government with a contractual entitlement to its share of the adjustment measured and assigned to a period in accordance with CAS 413-50(c)(12). In the recent Gould, Inc. decision, ASBCA No. 46759, dated September 19, 1997, both parties were in agreement that the Government was entitled to a share of the segment closing adjustment through the credits clause applicable to Gould's cost-type contracts.[3] The judge's decision clearly agreed there is

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[1] This memorandum addresses the provisions of CAS 412 and 413 that were in effect prior to the amendments that were published on March 30, 1995.

[2] "The applicable portion of any income, rebate, allowance, <u>or other credit</u> relating to any allowable cost and received by <u>or accruing to</u> the contractor shall be credited to the Government either as a cost reduction or by cash refund. See 31.205-6(j)(4) for rules related to refund or credit to the Government upon termination of an overfunded defined benefit pension plan."

[3] Kansas City's Medicare contracts have always been cost-type contracts subject to the FAR credits clause. The segment closing adjustment amount is based upon the initial allocation of assets in 1986 and the subsequent separate accounting of segment assets Kansas City's' cost-type Medicare contracts. This contractually agreed-upon initial allocation of assets represents the accumulated value of prior pension costs allocable to all lines of business, including any commercial work or fixed price contracts.

entitlement under the cost-type contracts. More importantly, the judge did not limit the amount of the Government's claim. In fact, the judge was persuaded by the testimony of Gould's own expert witness that the segment closing adjustment of "previously-determined pension costs" should be reflected on the appellant's books and records as an adjustment to pension cost in the period of the segment closing." The judge further noted that "the amount of overfunding would end up being a credit to the cost accounts."

Part of the testimony by Gould's expert witness, who was a member of the original CASB's Staff, noted the analogous treatment of gains and losses upon the sale of a depreciable asset under CAS 409-50(j)(1) and (3). Pension costs, like annual depreciation, are dependent upon estimated future values. When a future event, a segment closing or sale of an asset, changes that future estimate, then the CAS provides for an full immediate period adjustment to compensate for the over- or under-statement of the expected value during prior periods.

b) <u>Current period pension costs are based on liabilities incurred in the current period, prior periods, and expected to be incurred in future periods.</u>

Unlike other categories of cost, pension cost determinations are not limited to the benefit liability incurred in a single period. CAS 412-40(a)(1) states that there are four components of pension costs; namely, normal cost, a part of any unfunded actuarial liability, an interest equivalent on the unamortized portion of any unfunded actuarial liability, and an adjustment for any actuarial gains and losses. The computation of the normal cost and the actuarial liability for an ongoing segment covered by an ongoing pension plan includes recognition of service and earnings levels[4] that are estimated to be earned in future years. In the case of a 25-year old plan participant, this estimate may include projections for the next 40 years. The amortization installments, including an adjustment for interest, on this portion of unfunded actuarial liability is a current period charge for benefit liabilities earned by participants during prior periods. Since CAS 412 permits amortization of some portions of unfunded actuarial liability to be spread over 30 years, some of these current period charges can be attributable to benefit liabilities incurred 29 years ago. Likewise, the amortization installment for gains and losses can include current charges or credits for events that occurred up to 14 years earlier.

When developing and promulgating CAS 412, the original CASB and its staff considered restricting the pension cost for Government contracts to the recognition of only benefits earned in the current period. Because the actuarial liability is attributable to liability incurred for service rendered during prior periods, the actuarial liability, also known as the past service liability, was viewed as being an out of period cost. The accounting and actuarial communities persuaded the CASB that accepted accounting and actuarial practice spread the unfunded actuarial liability over

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[4] But see discussion under Issue # 3.

many years[5]. Thus, the CASB explicitly provided for the amortization of all portions of unfunded actuarial liability and thereby permitted a portion of liability earned and incurred in prior periods to be recognized and charged to contract costs in the current period.

Similarly, the original CASB and staff considered restricting the recognition of pension costs so that only the current level of benefits earned would be recognized. Again the accounting and actuarial professions convinced the CASB that accepted practices permitted recognizing projected salary levels and future service in the computation of pension cost. Additionally, the original CASB became aware that inter-period costs would be more stable, and therefore forward pricing would likewise be more stable, if period costing was based on reasonable future expectations.

If Kansas City's assertion was correct that the CASB limited pension costs to only current period considerations, then the CASB would have limited the measurement of pension costs to the normal cost and would not have permitted the recognition of future salary levels and service.

c) The original CASB intended and explicitly provided for CAS 413-50(c)(12) to measure an adjustment of prior period costs in a current period if a segment closed.

After CAS 412 was issued, the CASB and its staff began to look at the issues of "abnormal forfeitures"[6] and experience gains and losses. The abnormal forfeiture issue developed into two concerns. The first concern dealt with isolating material employment gains or losses to the segment wherein the loss occurred. The second concern was with the large gain that can occur when a plant or operational unit would close, often because of a loss of Government contract work. The first concern regarding abnormal forfeitures was addressed by the requirement for separate computation of segment costs if employee turnover differs significantly between segments. The second concern lead the Board to consider the general effects of a loss of Government contract work. The Board realized that the normal accounting for pension costs on an ongoing basis spread the costs of a single period event; such as establishment of a pension plan, plan amendment, plant closing, and experience gain or loss, over future cost accounting periods. However, when a segment closes there may not be any future contract periods during which the delayed portion of current and prior period liabilities and gains could be charged or credited to a Government contract(s).

Therefore, the CASB provided that a special current period adjustment be measured whenever a segment closed. The CASB knew that some portions of prior period liabilities and

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[5] The accounting and actuarial professions pointed out that past service credits are granted as an inducement to currently active employees in return for current and future service.

[6] "Abnormal forfeitures" were addressed as far back as 1965 in the Federal Procurement Regulation (FPR). The FPR was superseded by the FAR in 1984.

prior period gains and losses had been delayed and thus unrecognized. More importantly, there often could be substantial actuarial gains when an organizational unit ceased to exist. That gain would not be properly credited to Government contracts under the normal delayed recognition process if there were no future contracts. If the contractor had been able to foresee the substantial gain, prior period costs allocated to contracts would have been lower.[7] Because prior period costs were based on estimates about future events, some of which will have come to pass by the current period, the pension costs of prior periods were either too high or too low because the estimates deviated from actual results. The CASB decided that in such cases a current period adjustment, representing the over- or under-estimation of prior period costs, was necessary. Such an adjustment of prior period costs was explicitly provided for at CAS 413-50(c)(12).

d) CAS 413-50(c)(12) adjustment includes interest earned on Government's share of contributions held in trust fund.

It is well established that when funds are invested, the Government shares in the earnings, investment expenses, and the appreciation or depreciation attributable to those funds.[8] This principal was directly reflected in CAS 413-50(c)(7) which states:

> "After the initial allocation of assets, the contractor shall maintain a record of the portion of subsequent contributions, income, benefit payments, and expenses attributable to the segment and paid from the pension fund. Income and expenses shall include a portion of any investment gains and losses attributable to the assets of the pension fund. Fund income and expenses shall be allocated to the segment in the same proportion that the assets allocated to the segment bears to the total fund assets as of the beginning of the period for which fund income and expenses are being allocated."

The segment closing adjustment is not limited to the Government's share of contributions, but to the Government's share of any pension fund assets not required to provide for the actuarial liability earned by the Medicare segment's plan participants while rendering service under Medicare contracts.

2. The pension cost adjustment is constrained to only pension costs reimbursed since CAS 413 first became applicable to the Medicare contracts.

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[7] When a contractor inquired what was the proper accounting when the contract knew in advance that it would lay-off employees at the end of a contract, Bernie Sachs, a member of the original CASB Staff, advised the contractor to compute lower pension costs by anticipating the termination of employment gain from the expected lay-off.

[8] Refer to ITT Federal Support Services, Inc v. the United States, No. 138-73, United States Court of Claims, March 17, 1976.

I disagree.

See the discussion under Issue # 1.

As noted above, the accounting and actuarial communities persuaded the CASB that actual practice contemporaneous to the early 1970's included cost elements attributable to liabilities incurred in prior periods. CAS 412 was designed to permit most companies to generally continue their existing practices and methods for determining pension cost. Because of this, there was little change in the practices and methods employed in the determination of Government contract costs before and after CAS 412 and 413 became applicable. The original CASB, could have, but did not limit, the measurement of any CAS 413-50(c)(12) adjustment to only periods after CAS 413 was applicable.

There is no evidence that Kansas City changed its actuarial methods and techniques used for contract cost purposes when it became subject to CAS 412 and 413 in 1981. Prior to 1981, Kansas City's cost accounting practices for pension costs had to be acceptable under Accounting Principle Board's Opinion Number 8 in order to be allowable under the Federal Procurement Regulation. As noted above, the FAR and the CAS permitted the contractor to continue the same practices regarding pension costs after 1981.

Nor is the CAS 413-50(c)(12) segment closing adjustment a new requirement. The Cost Principals subcommittee responsible for the promulgation of the FAR viewed the CAS 413 segment closing provision as an evolution of the FPR's provision for an immediate period adjustment for an "abnormal forfeiture". Therefore the CAS 413-50(c)(12) can not be viewed or characterized as giving the Government new rights to an adjustment when an operational unit closes.

3. A projected benefit measure of liability should be used for those active Medicare employees within the Medicare segment or who transferred to the non-Medicare Segment.

I disagree.

CAS 413-50(c)(12) in effect at the time the Medicare segments closed required that the adjustment of previously determined pension costs be measured using the actuarial liability, but was silent on whether the actuarial liability recognized benefit increases due to future salary increases. Reading CAS 412 and 413 together, I note that CAS 412-50(b)(6) stated:

> "Pension cost shall be based on provisions of existing pension plans. This shall not preclude contractors from making salary projections for plans whose benefits are based on salaries and wages, or from considering improved benefits for plans which provide that such improved benefits must be made."

The language of this paragraph permits the contractor to anticipate future salary increases, but does not require that these increases be anticipated. Thus this paragraph allows the contractor to prefund a portion of the associated benefit increases and achieve a smoother, and therefore more consistent, pattern of pension costs between contract accounting periods. Anticipating salary increases while the segment is ongoing is appropriate since the salaries being anticipated will have a causal/beneficial relationship to work performed under Government contracts absent evidence to the contrary. And indeed, this is the basis on which Kansas City previously determined its pension costs and allocated them to the Medicare contracts.

However, when a segment closes, there is an end to the causal/beneficial relationship between future pay raises and the Government contract(s). A contractor may make a management decision to retain productive employees and to assign them to commercial lines of business. Commercial customers then benefit from the future productivity of these retained employees and are responsible for the costs associated with the salary increases paid for the future productivity. An underlying principle of the CAS, and Government contract accounting in general, has been that there must be a causal/beneficial relationship between the incurrance of a cost and the performance of a contract before that cost can be allocated to and allowed under that contract. Thus, it is inappropriate to recognize such future salary increases when determining the actuarial liability for the CAS 413-50(c)(12) segment closing adjustment.

4. The actuarial liabilities should be valued using a discount rate that reflects market conditions as of the date of the segment closing.

I disagree.

<u>a) Actuarial assumptions - discount (interest) rate assumption.</u>

CAS 413-50(c)(12) does not specify the interest rate to be used to determine the actuarial liability. Assumed interest rates, as well as all other actuarial assumptions, are addressed by CAS 412 which says:

> "Each actuarial assumption used to measure pension cost shall be separately identified and shall represent the contractor's **<u>best estimates</u>** of anticipated experience under the plan, taking into account past experience and reasonable expectations. The validity of the assumptions used may be evaluated on an aggregate, rather than on an assumption by assumption, basis." - CAS 412-40(b)(2) (Emphasis added)
>
> "Actuarial assumptions should reflect long-term trends so as to avoid distortions caused by short-term fluctuations." - CAS 412-50(b)(5)
>
> "If the evaluation of the validity of actuarial assumptions shows that, in the aggregate, the assumptions were not reasonable, the contractor shall: (I) identify the major causes for the

resultant actuarial gains or losses, and (ii) provide information as to the basis and rationale used for retaining or revising such assumptions for use in the ensuing cost accounting period(s)." - CAS 412-50(b)(7)

Paragraphs CAS 412-40(b)(2) and 50(b)(5) make it clear that the CAS Board intended that reasonable, long-term assumptions based on past performance and future expectations be used. Nowhere in either CAS 412 or 413 did the Board provide for the interest (discount) rate assumption to be based on current market conditions. While assumptions must be based on long-term expectations, CAS 412-40(b)(2) and 50(b)(7) do provide that assumptions should be updated for changes in future economic or population trends and expectations.

The actuarial liability used to determine the CAS 413-50(c)(12) adjustment was calculated by Kansas City's actuary, the Wyatt Company (Wyatt), and was based on the interest and mortality valuation assumptions used since 1988.[9] The auditors found no evidence that Kansas City or its actuary believed its valuation assumptions were unreasonable. In fact, the actuary each year certified that the assumptions represented his "best estimate" that Kansas City adopted as its own for ERISA and contract costing purposes.

At the close of the Medicare segment, Kansas City chose to continue the funding of the pension liability for former segment employees through a professionally managed trust. The interest assumption is therefore properly based upon the underlying investment decision of the contractor. Kansas City has made a financial decision to retain the investment risk and try to "beat" the long-term conservative interest assumption. Had Kansas City actually purchased annuity contracts, only then would the costs of such contracts establish the actuarial liability since the premium would have represented the value of future benefit payments to the participants.[10]

For purposes of CAS 413-50(c)(12), the actuarial liability is to be determined using an interest assumption based on past experience and long-term expectations concerning the investment yield of the underlying funding mechanism. The actuarial liability, as calculated Wyatt is based on valuation assumptions as of January 1, 1992, was appropriate for determining the adjustment required by CAS 413-50(c)(12).

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[9] Prior to 1988, the interest assumption was 8.5% for 1985, 9.0% for 1986, and 8.5% for 1987 for both ERISA and CAS purposes for that year. I also note that Wyatt lowered the interest assumption for NEBA pension plans to 8.5% for 1993 and then to 8.0% for 1994, but these changes were 2 years after the mutually agreed upon segment closing date. Wyatt then increased the interest assumption back to 8.5% for 1995 through 1997.

[10] Actually, after adjusting the premium for expected dividends, the resultant actuarial liability may have only differed from the liability used in the audit report by the cost assessed by the insurer for full risk assumption and profit.

b) Market versus actuarial value of assets.

Kansas City also asserted that using the market value of assets is inconsistent with the use of ongoing actuarial assumptions. The auditors properly followed CAS 413-50(c)(12) which requires that the adjustment be calculated as the "market value of assets" less the actuarial liability. Kansas City in its response even states "CAS 413-50(c)(12) specifically requires that the closed segment's pension assets be valued at market as of the date of the segment closing". Contrary to Kansas City's assertion, this requirement is consistent with the immediate period recognition of all deferred gains and losses.

Pension costs for ongoing segments are measured using the actuarial value of assets. The actuarial value of assets is typically determined based on the change in the market value of assets during the year with some portion of the annual asset gain or loss deferred to future periods through a delayed recognition process.[11] Just as the use of the actuarial liability causes all liability gains and losses to be recognized in the current period, instead of deferred to future periods, the use of the market value of assets causes immediate period recognition of all asset gains and losses. The CASB recognized that when a segment was closed there would be no future accounting periods in which to adjust unrecognized gains and losses, and therefore adopted the immediate period recognition for segment closings.

I compared the interest assumption with the gross and net rates of investment return for the Kansas City pension fund. Over the six year period the gross return on investments exceeded the interest assumption by 3.67% and exceeded the net return on investments by 3.01%. I looked ahead to 1992 and found that gross and net returns on investments were 3.99% and 3.49% respectively. The seven year average gross and net returns on investments, which were 11.28 and 10.45% respectively, still exceeded the assumed interest rate. Kansas City's "best estimate" interest rate assumption of 9.00% appears to be consistent, if not conservative[12], with the market investment results for the pension fund.

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[11] While there are many methods used to determine the actuarial value of assets, all methods share the attribute that recognition of some portion of the difference between the value of assets used for measurement of the annual cost and the true market value is deferred to future periods.

[12] Because an enrolled actuary's primary duty under ERISA is to certify to the adequacy of funding of the benefits promised to the pension plan's participants, my experience has been that most pension actuaries build some degree of conservatism into their valuation assumptions.

	1986	1987	1988	1989	1990	1991	6-Year Average
Gross Return on Investment[13]	16.06%	4.59%	13.92%	23.16%	- 2.52%	22.41%	12.67%
Net Return on Investment[14]	15.39%	3.92%	13.22%	22.39%	- 3.08%	21.78%	12.01%
Interest Assumption	9.00%	8.50%	9.00%	9.00%	9.00%	9.00%	9.00%

When preparing this table I computed the expected administrative expense using Wyatt's assumptions. I found that over the six-year period the actual administrative expense, which was used to derive the net return on investment, exceeded the assumed administrative expense. Therefore, the 9.00% interest assumption is not only reasonable, but the 9.00% assumption can be presumed to include a decrement for future administrative expenses.

Kansas City notes that market value will fluctuate over time and that the auditors should have employed a "smoother" asset valuation method, despite the specific provisions of CAS 413. I agree that market values do change over time and that we are in the midst of a historically long-lived "bull" market. However, Kansas City has presented no evidence of short term fluctuation causing a distortion so that the market value was aberrantly low or high on January 1, 1992[15]. While any such evidence might be of interest during audit resolution discussions with HCFA, the audit report recommendation must be based on the provisions of CAS 413-50(c)(12).

And finally, included in Kansas City's argument that the actuarial value is a more appropriate, albeit contradictory to the express language of CAS 413-50(c)(12), measure of the pension assets is the observation that the actuarial value of assets is less than the market value of assets as of January 1, 1992. This observation neither supports nor refutes their position, but it does raise the question of whether this same observation and argument would have been asserted it the actuarial value exceeded the market value. As with all other segment closing reports, the OIG pension auditors correctly followed the language of CAS 413-50(c)(12) without regard as to

[13] The gross rate of investment return was calculated by dividing the actual investment earnings by the average asset value during the year excluding the investment earnings.

[14] The net rate of investment return was calculated by dividing the actual investment earnings less the administrative expense by the average asset value during the year excluding the investment earnings and administrative expense.

[15] An example of an aberrant market value would be the market value on "black Monday", October 19, 1987, when the market lost 22.6% of its value in a single day.

whether another value would increase or decrease the report finding.

5. The report misstates the amount of the actuarial liabilities attributable to the Medicare Segment because the calculation of the actuarial liabilities of the Medicare Segment should consider the present value of administrative expenses.

I disagree.

The actuarial liabilities provided to the auditors by Kansas City's actuary, both on an accrued benefit basis and on a projected benefit basis, were developed using the methods and assumptions that had been consistently used for determining pension costs for the Medicare contract, as well as for ERISA purposes. As discussed under subsection (b) of Issue # 4, these assumptions and method do provide for administrative expenses. The auditors have made no adjustments to remove or change the recognition of administrative expenses in the actuarial liabilities provided by Kansas City's actuary.

This same issue was addressed in the recent Gould, Inc. decision, ASBCA No. 46759, dated September 19, 1997. In this case the judge accepted the Government's expert witness's testimony that the segment closing lowered the administrative expense because inactive employees cause less actuarial and record-keeping expenses. As discussed under the topics concerning retained employees and future salary levels, while Kansas City did not terminate all its Medicare segment employees, the Government neither benefits from nor causes the higher future administrative expense associated with active employees which Kansas City decided to retain to serve its non-Medicare customers.

6. The amount of the segment's pension assets may be misstated due to the asset transfer methodology.

I disagree that the segment's pension assets may be misstated due to the asset transfer methodology.

As plan participants transfer between segments, retire or otherwise terminate, Kansas City's actuary has transferred their actuarial liability and assets to the degree that the actuarial liability for the originating active segment was funded. If the actuarial liability was fully funded, then Wyatt transferred an amount equal to the actuarial liability. The relevant sentence of CAS 413-50(c)(9) reads:

When assets transferred are equal to the portion of actuarial liability transferred, then any actuarial surplus that had accumulated in a segment would remain with that segment and eventually be allocated to the final cost objectives (lines of business) of that segment, regardless of whether the segment performed government, commercial, or mixed operations. Besides the guidance of CAS 413-50(c)(12), the illustration at CAS 413-60(c)(1) directly demonstrates the

CAS requirement to retain any gains or losses in the segment in which they arose. This requirement implements the CASB's general concept of recognizing the causal or beneficial basis of costs. In this case, gains and losses (contract credits or charges) are recognized in the appropriate segment and allocated to the cost objectives of that segment.

The auditors followed these established practices of Kansas City. The auditors have consistently accepted these practices used by most members of the NEBA program. It is highly inappropriate for Kansas City to question its own established practices in a response to an OIG audit report.

7. The report should consider HCFA's responsibility for the portion of unfunded post-retirement benefit liability that is attributable to its Medicare contracts.

I disagree.

While performing the on-site portion of this audit, the auditors ascertained that Kansas City had established the pay-as-you-go cost method as the cost accounting practice for measuring and assigning post-retirement benefit costs for allocation to Medicare contracts. In its response Kansas City acknowledges that the pay-as-you-go cost method was used to claim post-retirement benefit costs under its Medicare contracts. The pay-as-you-go cost method, which is one of the two accounting methods that a contractor is permitted to choose under FAR 31.205-6(o), does not develop an unfunded liability. Since the pay-as-you-go cost method does not actuarially determine the cost for a period, a specialized review by the Region 7 pension auditors was not necessary. I understand that the auditors performing the administrative cost and termination cost audits will be responsible for reviewing these costs.

Secondly, the only costs Kansas City allocated to the Medicare contracts for post-retirement benefits were based on the pay-as-you-go cost method. To my knowledge, Kansas City had never submitted a claim for post-retirement benefit costs based on accrual accounting, the other accounting method permitted by FAR 31.205-6(o), prior to the date of their May 24, 1998 letter. Therefore, there was no unfunded post-retirement benefit liability claimed and susceptible to audit.

Finally, one of the primary principles of government contract costing is that a cost must be incurred, accumulated, and accounted for on the same basis on which the cost was proposed. Regardless of whether the cost is allocated to a negotiated fixed-price contract or a cost-type contract, HCFA negotiates contractor budgets based on proposed costs included in the Budget and Performance Requirement (BPR) process and obligates funds through the Notice Of Budget Approval (NOBA) process. If Kansas City had chosen to base its cost proposals on accrual accounting in prior periods, HCFA would have had an opportunity to consider the difference in cost in its request for congressional appropriations and when allocating administrative funds among all the contractors. Furthermore, one of the ways HCFA assesses each contractor's efficiency is by a comparison of cost. Kansas City is inappropriately requesting a retroactive change in accounting practice after the budget allocation, funds commitment, and efficiency assessment processes are finished. This is not only inequitable to HCFA, but the other Medicare contractors as well. Even if Kansas City had submitted a claim for unfunded post-retirement benefit obligations during the performance of the pension audit, the auditors would have had to recommend disallowance.

Please contact me at (410)-786-6381 or EShipley@HCFA.GOV if you have any questions.

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