Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF UNFUNDED PENSION COSTS OF ARKANSAS BLUE CROSS AND BLUE SHIELD

JUNE GIBBS BROWN
Inspector General

SEPTEMBER 1998
A-07-98-02526

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-07-98-02526

SEP 3 1998

Mr. Charles Clem
Vice President, Public Programs
Arkansas Blue Cross and Blue Shield
601 Gaines Street
Little Rock, Arkansas 72201

Dear Mr. Clem:

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 Arkansas Blue Cross and Blue Shield.* The purpose of our review was to compute interest on the January 1, 1992 accumulated unfunded pension costs and to determine if pension costs allocable to the Medicare contracts for plan years 1992 through 1996 were funded in accordance with the Federal Acquisition Regulations (FAR).

During our previous review of Arkansas Blue Cross and Blue Shield (Arkansas) (CIN: A-07-93-00678), we determined that the Medicare segment accumulated $955,454 in unfunded pension costs as of January 1, 1992. We recommended that Arkansas identify those unfunded pension costs as an unallowable component of subsequent years' pension cost calculations. We also recommended that Arkansas update the accumulated unfunded pension costs, and identify and track similar costs occurring in later years.

Our current review showed that Arkansas did identify and update the accumulated unfunded pension costs from 1992 through 1996, and that there were no additional unfunded pension costs during this period. However, we determined that Arkansas understated its accumulated unfunded pension costs by $153,269 as of January 1, 1997. The understatement occurred because Arkansas inappropriately began amortizing the accumulated unfunded costs as a component of the Medicare segment's pension costs in 1996.

We recommend that Arkansas increase the January 1, 1997 accumulated unfunded pension costs of the Medicare segment by $153,269. We also recommend that Arkansas obtain approval of its contracting officer before including any portion of the accumulated unfunded costs as a component of the Medicare segment's pension costs.

Arkansas concurred with our finding and recommendations. Their response to our draft audit report is included in its entirety as Appendix A.

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 Office of Federal Procurement Policy, Cost Accounting Standards Board, revised the CAS relating to accounting for pension costs on March 30, 1995. Unless otherwise noted, the following references to the CAS refers to the standards that were in effect before the revision. For purposes of clarity, we will refer to the post revision standards as the "revised" CAS. Applicable portions of the revised CAS are discussed in a following section.

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

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

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

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

Furthermore, the FAR, 48 CFR 31.205-6(j)(3)(i) and (iii), states:

> *...costs of pension plans not funded in the year incurred, and all other components of pension costs...assignable to the current accounting period but not funded during it, shall not be allowable in subsequent years....*
>
> *Increased pension costs caused by delay in funding beyond 30 days after each quarter of the year to which they are assignable are unallowable.*

Employees Retirement Income Security Act of 1974 (ERISA)

The FAR funding requirement has traditionally been satisfied by trust fund deposits qualifying for tax-exemptions under ERISA. The ERISA provided for a minimum and a maximum deposit to pension funds as determined each year. The minimum represented a required deposit while the maximum represented the upper limit that could be deducted for income tax purposes for the year which the deposit was applicable.

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

Conversely, if CAS pension costs before 1986 were greater than maximum ERISA contributions, contractors could deposit the CAS amounts in qualified trust funds, claim them as allowable contract costs, and take ERISA maximums as tax deductions. The excess of the CAS amount over the ERISA maximum could be carried forward to future years for tax deductibility. Similarly, if contractors deposited ERISA maximums that were larger than CAS computed amounts, differences could be carried forward to fund allowable contract costs for future years.

Tax Reform Act of 1986 (TRA 86)

The TRA 86 changed the effect of making pension plan contributions in excess of ERISA maximums. The ERISA maximum was still the tax deductible limit and the excess could still be carried forward to future years for deductibility. However, TRA 86 imposed an excise tax of 10 percent on contributions in excess of ERISA maximums. The excise tax is cumulative from year to year and applied on a first-in/first-out basis considering carry-forwards and current year contributions.

Omnibus Budget Reconciliation Act of 1987 (OBRA 87)

Prior to OBRA 87, ERISA's full funding limitation traditionally considered accumulated assets and the actuarial liability. If assets equaled or exceeded the actuarial liability, the tax deductible amount was limited to zero. With OBRA 87, the Congress took additional action affecting contractors' pension plan contributions to qualified trust funds.

The OBRA 87 imposes a second more restrictive test to the full funding limitation. It considers the accumulated assets and 150 percent of the amount designated "current liability." The actuarial liability under the pre-OBRA 87 test was based on projected benefits and conservative valuation assumptions. The current liability test of OBRA 87 considers only currently accrued benefits and values the liability using interest rates based on Treasury rates. The effect was that most pension plans that were already in full funding would remain there longer. Also, the same effect pushed additional plans into full funding.

Revised CAS

As previously noted, the CAS relating to accounting for pension costs was revised on March 30, 1995, and became applicable to contractors with the start of the first accounting period thereafter. The revised CAS removed the regulatory conflict between the funding limits of ERISA and the period assignment provisions of the CAS. The transition provisions of the new rule allows the assignment of prior period pension costs, with interest, which were not funded because they lacked tax deductibility. However, the method or methods used to reassign the unfunded pension costs must be approved by the contracting officer.

The introductory portion of the transition provisions within 48 CFR 9904.412-64 states in part:

> "To be acceptable, any method of transition from compliance with Standard 9904.412 in effect prior to March 30, 1995, to compliance with the Standard effective March 30, 1995, must follow the equitable principle that costs, which have been previously provided for, shall not be redundantly provided for under revised methods. Conversely, costs that have not previously been provided for must be provided for under the revised method. This transition subsection is not intended to qualify for purposes of assignment or allocation, pension costs which have previously been disallowed for reasons other than ERISA tax-deductibility limitations. ...The method, or methods, employed to achieve an equitable transition shall be consistent with the provisions of Standard 9904.412, effective March 30, 1995, and shall be approved by the contracting officer."

Specific guidance on prior unfunded costs is found at 48 CFR 9904.412-64(a)(1):

> "Any portion of pension cost for a qualified defined-benefit pension plan, assigned to a cost accounting period prior to March 30, 1995, which was not funded because such cost exceeded the maximum tax-deductible amount, determined in accordance with ERISA, shall be assigned to subsequent accounting periods, including an adjustment for interest, as an assignable cost deficit. However, such costs shall be assigned to periods on or after March 30, 1995, only to the extent that such costs have not previously been allocated as cost or price to contracts subject to this Standard."

OBJECTIVE, SCOPE, AND METHODOLOGY

We made our examination in accordance with generally accepted government auditing standards. Our objective was to identify any unfunded CAS costs, plus interest adjustments on the unfunded costs, from January 1, 1992 to January 1, 1997. Our objective also included identifying interest adjustments on the unfunded pension costs previously reported. Achieving our objective did not require that we review the internal control structure of Arkansas.

We performed this review in conjunction with our audits of pension segmentation (CIN: A-07-97-02524), and pension costs claimed for Medicare reimbursement (CIN: A-07-98-02525). The information obtained and reviewed during these 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 Arkansas' historical practices.

We performed site work at Arkansas' corporate offices in Little Rock, Arkansas during March and April 1998. Subsequently, we performed audit work in our Jefferson City, Missouri office.

FINDING AND RECOMMENDATIONS

As of January 1, 1997, Arkansas identified accumulated unfunded pension costs of $1,263,605 related to its Medicare segment. We determined that the Medicare segment's accumulated unfunded pension costs were $1,416,874 as of January 1, 1997. Therefore, Arkansas understated the accumulated unfunded pension costs by $153,269. This understatement occurred because Arkansas inappropriately began amortizing the accumulated unfunded costs as a component of the Medicare segment's pension costs in 1996.

For plan years 1992 through 1996, Arkansas made contributions to their pension plan in excess of the CAS pension costs. Consequently, there were no additional unfunded pension costs during this period.

For plan years 1992 through 1995, Arkansas correctly identified and updated the Medicare segment's accumulated unfunded pension costs. However, as of January 1, 1996 Arkansas began amortizing the Medicare segment's accumulated unfunded pension costs as a component of the segment's 1996 pension costs. Arkansas amortized the unfunded costs using the methodology set forth in the revised CAS. As of January 1, 1997 Arkansas' unamortized balance of the accumulated unfunded pension costs was $1,263,605.

The revised CAS, applicable to Arkansas beginning with plan year 1996, does provide for the amortization and assignment of accumulated unfunded pension costs. However, the revised CAS requires that the method or methods used to reassign the unfunded pension costs must be approved by the contracting officer. Arkansas had not received such approval at the time of our review. Therefore, Arkansas' amortization of the accumulated unfunded pension costs as a component of allowable costs was inappropriate.

The following table shows our update of the accumulated unfunded amounts, with interest, from January 1, 1992 to January 1, 1997.

Unfunded CAS Pension Costs and Interest

Date	Accumulated Unfunded CAS Cost & Interest	Interest to End of Year
01/01/92	$955,453	$85,991
01/01/93	$1,041,444	$83,316
01/01/94	$1,124,760	$89,981
01/01/95	$1,214,741	$97,179
01/01/96	$1,311,920	$104,954
01/01/97	$1,416,874	

Our computation of the accumulated unfunded amounts plus interest utilized Arkansas' valuation rates of interest. Those rates were 9 percent for 1992, and 8 percent for years 1993 through 1996.

Recommendations

We recommend that Arkansas:

- Increase the accumulated unfunded pension costs of the Medicare segment by $153,269 as of January 1, 1997.

- Obtain approval from its contracting officer before including any portion of the accumulated unfunded pension costs as a component of the Medicare segment's CAS pension costs.

Auditee Response

Arkansas concurred with our finding and recommendations. Their response to our draft audit report is included in its entirety as Appendix A.

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 on the following page. 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

Enclosure
HHS Action Official:
Dr. James Farris
Regional Administrator, Region VI
Health Care Financing Administration
1301 Young Street, Room 714
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Arkansas
BlueCross BlueShield

601 S. Gaines St.
P.O. Box 2181
Little Rock, Arkansas 72203-2181

August 24, 1998

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

SUBJECT: CIN A -07-98-02524

Dear Ms. Bennett:

We are in receipt of the draft report of the recent reviews of our pension plan. We are in agreement with the recommendations presented and find them to properly reflect the results of actions discussed during the field work by your staff. We had previously used a rather strict definition for cost centers to include in the Medicare segment so the recommendation to decrease the value of assets assigned to the segment was expected. Further, we have forwarded to the HCFA Central Office all of the required documentation related to approval for reassignment of the unfunded pension costs, but, as you stated, this has not been finalized at this time.

These audit results have been sent on to our pension plan actuaries for their inclusion in valuation data associated with these time periods. Also, we will be working with our regional office on the cost reimbursement issues raised in the report titled "Review of Pension Costs Claimed for Medicare Reimbursement by Arkansas Blue Cross and Blue Shield".

Ms. Barbara A. Bennett
August 24, 1998
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I would like to express my thanks to your staff for the very cordial manner in which they conducted this audit. Please let me know what other actions are necessary at this time.

Sincerely,

Beverly C Villines

Beverly C. Villines, Director
Corporate Accounting

cc: Charles Clem, Vice President, Public Programs
Steven Short, Vice President, Financial Services
David Greenwood, Government Programs Accounting
Sylvia Shaw, Human Resources Administration
Faye Deacon, Hewitt Associates