DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date FEB 22 2002

Thomas D. Roslewicz

From Thomas D. Roslewicz
Deputy Inspector General
for Audit Services

Subject Audit of the Pension Plan at a Terminated Medicare Contractor, Independence Blue Cross (A-07-01-00132)

To Neil Donovan
Director, Audit Liaison Staff
Centers for Medicare & Medicaid Services

As part of an ongoing collaborative effort between the Office of Inspector General and the Centers for Medicare & Medicaid Services (CMS), we are alerting you to the issuance within 5 business days from the date of this memorandum of our final report entitled, "Audit of the Pension Plan at a Terminated Medicare Contractor, Independence Blue Cross." A copy of the report, identifying about $2.9 million in excess pension assets at Independence Blue Cross (IBC) is attached.

We suggest that you share this report with the CMS components involved with monitoring the Medicare contractor financial operations, particularly the Office of Financial Management, the Center for Medicare Management, and the Office of the Actuary.

The IBC was a Medicare contractor until their contract was terminated in 1997 and, as such, was allowed to claim Medicare reimbursement for their Medicare employees' pension costs. Regulations and the Medicare contracts provide, however, that pension gains, which occur when a Medicare segment of a pension plan closes, should be credited to the Medicare program. Accordingly, we are recommending that IBC remit about $2.9 million in excess pension assets to the Medicare program.

The IBC disagreed with certain fundamental aspects of our calculations, and asserted that they found no basis to depart from their own computations.

If you need additional information about this report, please contact James P. Aasmundstad, Regional Inspector General for Audit Services, Region VII, (816) 426-3591.

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

AUDIT OF THE PENSION PLAN AT A TERMINATED MEDICARE CONTRACTOR, INDEPENDENCE BLUE CROSS

JANET REHNQUIST
Inspector General

FEBRUARY 2002
A-07-01-00132

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-07-01-00132

FEB 26 2002

Mr. John Foos
Chief Financial Officer
Independence Blue Cross
1901 Market Street
Philadelphia, Pennsylvania 19103-1480

Dear Mr. Foos:

This report provides the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review entitled, *Audit of the Pension Plan at a Terminated Medicare Contractor, Independence Blue Cross*. The purpose of our review was to evaluate Independence Blue Cross's (IBC) compliance with the pension segmentation requirements of its Medicare contract and to determine the excess assets that should be remitted to Medicare as a result of the termination of the Medicare contractual relationship effective September 30, 1997.

We computed excess pension assets of $2,913,129, which IBC should remit to the Federal Government. The IBC disagreed with certain fundamental aspects of our calculations, and asserted that they found no basis to depart from their own computations. The IBC's response is included in its entirety as Appendix C. Appendix D contains the Centers for Medicare & Medicaid Services (CMS), Office of Actuary's comments on IBC's response.

INTRODUCTION

BACKGROUND

The IBC administered Medicare Part A under cost reimbursement contracts until the contractual relationship terminated in 1997. In claiming costs, contractors were to follow cost reimbursement principles contained in the Federal Procurement Regulations (FPR), which were superseded by the Federal Acquisition Regulations (FAR), the Cost Accounting Standards (CAS), and the Medicare contracts.

Since its inception, Medicare has paid a portion of the annual contributions made by contractors to their pension plans. These payments represented allowable pension costs under 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 CMS, formerly the Health Care Financing Administration 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.

The Medicare contract defines a segment, and specifies the methodology for the identification and initial allocation of pension assets to the Medicare segment. Furthermore, the contract requires that the Medicare segment assets be updated for each year after the initial allocation in accordance with CAS 413.

The IBC's contract required (1) computing the Medicare segment's actuarial liability, (2) determining the ratio of 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 agreement/contract, 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 provide for separate identification of the pension assets of the Medicare segment. The identification involves 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 was to use the ratio of the actuarial liabilities of the Medicare segment to the actuarial liabilities of the total plan, as of the later of the first day of the first plan year after December 31, 1980, or the first day of the first pension plan year following the date such Medicare segment existed.

The IBC's Medicare Part A contract was terminated in September 1997. Contract terminations and segment closings are addressed by CAS at 9904.413-50(c)(12), which states:

> "If a segment is closed, ...the contractor shall determine the difference between the actuarial accrued 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 difference between the market value of the assets and the actuarial accrued liability for the segment represents an adjustment of previously determined pension costs.
>
> (i) The determination of the actuarial accrued liability shall be made using the accrued benefit cost method. The actuarial assumptions employed shall be consistent with the current and prior long-term assumptions used in the measurement of pension costs....
>
> (iii) The calculation of the difference between the market value of the assets and the actuarial accrued liability shall be made as of the date of the event (e.g. contract termination, plan amendment, plant closure) that caused the closing of the segment.... If such a date is not readily determinable, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date."

Medicare contracts specifically prohibit any profit (gain) from Medicare activities. Therefore, according to the contract, pension gains that 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)).

OBJECTIVES, SCOPE, AND METHODOLOGY

We made our examination in accordance with generally accepted government auditing standards. Our objectives were to determine IBC's compliance with pension segmentation requirements of its Medicare contract, and to determine the amount of excess assets that should be remitted to Medicare as a result of the contract termination and Medicare segment closing. Achieving our objectives did not require a review of IBC's internal control structure. The audit addressed IBC's initial determination of pension assets for its Medicare segment and later updates. Our review covered July 1, 1981 to September 30, 1997.

This review was done in conjunction with our audit of costs claimed for reimbursement (A-07-01-03003). The information obtained and reviewed in that audit was also used in performing this review.

The IBC's Medicare contract was terminated in September 1997. The IBC suggested, and we agreed, that September 30, 1997 would be an appropriate settlement date for the closing of the segment. We, therefore, reviewed IBC's identification of the Medicare segment and its update of Medicare assets from July 1, 1986 to September 30, 1997 and traced the segment's organizational lineage back to 1981. We also reviewed IBC's computation of the asset fraction.

In performing the review, we used information provided by Alexander and Alexander, and PriceWaterhouse Coopers, IBC's consulting actuaries. The information included liabilities, normal costs, contributions, benefit payments, earnings, and administrative expenses. We reviewed IBC's accounting records, pension plan documents, annual actuarial valuation reports, and the Department of Labor/Internal Revenue Service Form 5500s. Using these documents, we calculated Medicare segment assets as of September 30, 1997. The CMS pension actuarial staff reviewed our methodology and calculations.

Site work at IBC's corporate offices in Philadelphia, Pennsylvania was performed during January 2000. We performed subsequent audit work in our OIG, OAS Jefferson City, Missouri field office.

FINDINGS AND RECOMMENDATIONS

When IBC's Medicare segment closed, Medicare's share of the excess pension assets was $2,913,129, which we are recommending be remitted to CMS. To determine Medicare's share, it was necessary to (1) establish the Medicare segment's initial pension assets as of July 1, 1986, (2) update the segment assets to September 30, 1997, and (3) calculate the actuarial accrued liability for accrued benefits for the segment, and the excess Medicare assets.

MEDICARE ASSETS AS OF JULY 1, 1986

We determined that IBC's asset fraction was understated by 3.9535 percent. The IBC omitted 8 Medicare cost centers (containing 73 participants) from the Medicare segment. We increased the asset fraction from 0.82096 percent to 4.7745 percent by including the missing participants. Our calculations increased the Medicare segment assets by $1,324,865 to $1,599,976.

The IBC omitted certain cost centers from its 1981 asset fraction calculation. However, IBC included these same cost centers in its identification of the Medicare segment for 1986. We determined that these cost centers, containing 73 participants, met the contractual specifications for a segment and included the cost centers in our asset fraction calculation. The following schedule shows the details of IBC's and our calculations.

		1981 Total Actuarial Liability (A)	1981 Medicare Actuarial Liability (B)	1981 Rounded Asset Fraction (C)=(B)/(A)	1986 Total Company Assets 1/ (D)	1986 Medicare Segment Assets 1/ (E)=(C)(D)
OIG Calculation		$20,327,543	$970,526	4.7745%	$33,510,864	$1,599,976
IBC Calculation	2/	$19,748,904	$162,130	0.82096%	$33,510,864	$ 275,111
Difference				3.9535%	$0	$1,324,865

1/ Market Value of Assets (MVA)
2/ IBC applied their asset fraction to the actuarial value of assets (AVA) in their questionnaire response. We computed the asset split and the update of segment assets (see Appendix A) using the MVA. For purposes of comparison, we applied IBC's asset fraction to the MVA in the above illustration.

MEDICARE ASSET BASE AS OF JULY 1, 1986 UPDATED TO SEPTEMBER 30, 1997

The IBC's methodology in updating the Medicare segment assets from July 1, 1986 to September 30, 1997 resulted in an understatement of Medicare segment assets of $2,326,755. This understatement primarily occurred because IBC started the update with an understated asset base for 1986. When considered with the 1986 adjustment, IBC understated Medicare pension assets by $3,651,620.

Benefit Payments

Due to the incorrect identification of the Medicare segment participants, IBC's update of the segment assets did not properly identify benefit payments to retirees that were segment participants. We identified the actual benefits paid to the retirees from the Medicare segment and assigned these costs to the Medicare segment. This resulted in a net reduction of $138,559 in the Medicare segment assets. A comparison of IBC's and our computed benefit amounts are shown on the following schedule:

Benefit Payments To Medicare Retirees

YEAR	IBC	OIG	VARIANCE
1986	$2,539	$9,948	($7,409)
1987	9,124	20,433	(11,309)
1988	19,779	31,242	(11,463)
1989	20,438	33,403	(12,965)
1990	26,254	39,219	(12,965)
1991	27,034	40,000	(12,966)
1992	29,376	41,561	(12,185)
1993	63,760	76,725	(12,965)
1994	14,687	21,171	(6,484)
1995	29,376	42,341	(12,965)
1996	117,230	130,195	(12,965)
1997	30,447	42,365	(11,918)
Total	$390,044	$528,603	($138,559)

Participants and Transfers

In the update of pension assets, IBC misidentified Medicare segment participants. The IBC incorrectly included participants in non-Medicare cost centers and incorrectly excluded participants in Medicare segment cost centers. Since the identification of participants was incorrect, transfers (representing the movement in and out of the segment each year) in the updates were also incorrect. In comparison, IBC's and our computation of net transfer amounts were as follows:

Net Transfer Adjustments To The Medicare Segment

YEAR	IBC	OIG	VARIANCE
1986	($71,969)	$0	($71,969)
1987	107,070	4,645	102,425
1988	(251,518)	(6,145)	(245,373)
1989	(72,981)	90,376	(163,357)
1990	(6,261)	(154,097)	147,836
1991	(11,914)	(28,509)	16,595
1992	(7,260)	(23,139)	15,879
1993	(55,240)	58,070	(113,310)
1994	(44,002)	(182,738)	138,736
1995	(53,558)	(140,633)	87,075
1996	588	(165,924)	166,512
1997	0	(1,302,294)	1,302,294
	($467,045)	($1,850,388)	$1,383,343

We corrected the identification of the segment participants and transfer amounts in updating the Medicare segment pension assets. Our corrections to the transfer amount decreased the Medicare segment assets by $1,383,343.

Pension Contributions and Prepayment Credits

The IBC's update methodology did not equitably assign pension contributions to the Medicare segment. As a result, IBC understated Medicare segment assets by $345,295. This understatement occurred primarily because IBC incorrectly identified the Medicare segment plan participants, resulting in erroneous allocations of pension contributions.

The IBC allocated a portion of the total company pension contributions to the Medicare segment based on the ratio of the segment's salaries to the total company salaries. Since IBC's identification of the segment participants was incorrect, the allocation of pension contributions was also incorrect.

Additionally, for years 1993 and 1994, IBC's assigned contributions exceeded the required funding of the CAS pension costs (see Appendix A). According to CAS 9904.412-50(c)(1), amounts funded in excess of pension costs (or prepayments) shall be carried forward with interest to fund future CAS pension costs. We considered these excess contributions in our computations and made prepayment adjustments to fund the CAS pension costs of the Medicare segment.

We assigned contributions to the Medicare segment using the pension costs as calculated by the CMS Office of the Actuary. We assigned an equitable portion of the total company contributions to the Medicare segment, based on the ratio of the Medicare segment CAS funding target to the total company CAS funding target (see Appendix A). Our calculations increased the Medicare segment assets by $345,295. A comparison of IBC's and our calculation of pension contributions follows:

Contribution Variance For The Medicare Segment

YEAR	IBC	OIG	VARIANCE
1986	$158,761	$221,044	($62,283)
1987	189,896	124,317	65,579
1988	34,355	0	34,355
1989	0	288,257	(288,257)
1990	68,795	0	68,795
1991	0	82,665	(82,665)
1992	0	153,283	(153,283)
1993	101,884	51,445	50,439
1994	101,040	34,156	66,884
1995	72,837	176,308	(103,471)
1996	75,614	17,002	58,612
1997	0	0	0
Total	$803,182	$1,148,477	($345,295)

Earnings and Expenses

The IBC's update methodology allocated investment earnings and expenses based on a ratio of Medicare segment assets to total company assets. Because IBC's asset amounts were incorrect, it understated the segment's earnings and expenses for each year of the update. Except for using our adjusted asset values, we used IBC's allocation methodology in our update and increased the Medicare segment assets by $3,503,362.

Medicare Assets as of September 30, 1997

We updated pension assets of the Medicare segment from July 1, 1986 to September 30, 1997 (see Appendix A). Our calculation showed that assets of the Medicare segment increased by $3,651,620 to $4,746,074 as of September 30, 1997. This increase resulted from: (1) revising the asset fraction ($1,324,865 increase), (2) adjusting for benefit payments ($138,559 decrease), (3) adjusting for participant transfers ($1,383,343 decrease), (4) assigning pension contributions equitably to the Medicare segment ($345,295 increase), and (5) revising net segment earnings and expenses ($3,503,362 increase).

CALCULATION OF ACTUARIAL LIABILITY AND EXCESS MEDICARE PENSION ASSETS

We computed the Medicare actuarial accrued liability for accrued benefits to be $1,633,091. This amount includes the accrued liability of participants who were in the Medicare segment as of the termination date. After considering the Medicare segment assets of $4,746,074, the excess segment assets as of September 30, 1997 were $3,112,983. However, because the segment was not 100 percent devoted to Medicare operations, only a portion of the excess segment assets is attributable to Medicare.

To arrive at Medicare's share of the excess assets, we calculated the aggregate percentage of the segment to be 93.58 percent (see Appendix B). After applying the Medicare percentage of 93.58 to excess segment assets of $3,112,983, the resulting amount of $2,913,129 represents the portion attributable to Medicare. Because of the termination of the Medicare contract, this excess must be remitted to the Federal Government.

Recommendation:

We recommend that IBC refund $2,913,129 of excess Medicare pension assets resulting from the termination of its Medicare contract to CMS.

Auditee's Comments

The IBC's comments are summarized in the following paragraphs and presented in detail in Appendix C.

The IBC disagreed with our report and stated:

> "…IBC sees no basis to depart from the calculations it provided to your Office in September 1999, including the initial asset fraction calculation, the asset "roll-up," and the funded status as of September 30, 1997. Therefore, to the extent there are differences between those calculations and information in the draft Reports, IBC disagrees with those aspects of the draft Reports. Also,…IBC disagrees with certain fundamental aspects of the draft Reports that likely impact all or many of the calculations in those Reports."

The IBC noted that the primary difference between their calculations and ours was due to the differences in our computation of the asset fraction and initial allocation of Medicare segment assets. The IBC contends that we: (1) incorrectly identified the 1981 Medicare segment participants and actuarial accrued liability, thereby overstating the numerator of the asset fraction, (2) used an incorrect denominator for the asset fraction, and (3) applied the asset fraction to an incorrect asset base as of the initial allocation date.

The IBC acknowledged that in 1989 correspondence with CMS, IBC identified its 1981 Medicare segment as the organizational subdivision known as "Provider Services." However, subsequent to the contract termination in 1997, IBC revised that identification. In justifying that revision, IBC stated:

> "…in retrospect, IBC realized that such a broad definition is virtually unworkable for the type of pension calculations required by the Contract. Because it was necessary to recreate the initial asset allocation and the asset roll-up, IBC determined that the use of an appropriate but more manageable Medicare segment was prudent. For purposes of recreating an appropriate segment, and performing an initial asset allocation and a yearly asset roll-up, IBC redefined the 1981 Medicare segment to include a smaller, more appropriate group of participants."

Furthermore, IBC stated that their revised definition strictly complied with the Medicare contract's definition of "Medicare segment." In support of their position, IBC cited selected portions of the contract.

The IBC took exception to our statement in the audit report that they omitted certain cost centers from its 1981 asset fraction calculation, but included those same cost centers in their identification of the 1986 Medicare segment. The IBC contends that there is no connection between the 1981 Medicare segment and the 1986 Medicare segment. The IBC stated:

> "…the 1986 segment is irrelevant to identifying the 1981 segment for purposes of determining the asset fraction. The Contract required that the segment's liabilities be

identified in 1981. As such, the status of the segment five years later plays no role under the Contract in calculating the asset fraction."

With respect to the denominator of the asset fraction, IBC noted that we used a larger amount than IBC used for its computation of the asset fraction. The IBC also noted that our use of a larger denominator would have resulted in a smaller asset fraction than IBC computed if our numerators had been the same, which they were not.

The IBC noted that we applied our asset fraction to the market value of pension fund assets, in computing the Medicare segment's initial asset allocation. The IBC further noted that the Medicare contract requires the asset fraction to be applied to the actuarial value of pension fund assets. The IBC pointed out that the asset fraction was applied to the actuarial value of pension fund assets in IBC's computation of the segment's initial assets.

The IBC maintains that its "roll-up" of Medicare segment assets from the initial allocation up to the segment closing date was performed in accordance with CAS. Additionally, IBC maintains that its roll-up of segment assets was based on IBC's identification of the Medicare segment, which IBC claims was in compliance with the Medicare contract. The IBC determined that the Medicare segment's actuarial value of pension assets was $954,780 as of September 30, 1997. The IBC also noted that we computed our roll-up of Medicare segment assets on the market value of assets instead of the actuarial value.

The IBC questioned our identification of the Medicare segment for purposes of the roll-up and the segment closing adjustment; implying that we relied upon some definition of the Medicare segment other than that set forth in the Medicare contract.

The IBC identified the segment's actuarial accrued liability as $3,525,418 as of September 30, 1997. The IBC converted the segment's actuarial value of assets as of September 30, 1997 to the market value of assets, based on the ratio of the segment's actuarial value of assets to total company actuarial value of assets. The IBC then computed the segment's "funded status" as follows:

Market Value of Assets	$ 1,094,454
Less: Actuarial Accrued Liability	3,525,418
Funded Status	$(2,430,964)

Per IBC's computations, the Medicare segment was underfunded by $2,430,964 as of September 30, 1997. The IBC asserted that our differences in the identification of the Medicare segment largely accounted for the differences in our segment closing adjustments. The IBC added that, "…we cannot discern the basis for the Government's identification of the segment, while IBC's segment determination complies strictly with the Contract and should be used to perform the required calculations."

Finally, IBC asserted that our reports did not identify our interpretation of the Medicare contract segment definition, or how we applied that interpretation to IBC. Likewise, two separate requests for such information subsequent to the issuance of the draft reports still did not provide the answer as to how we interpreted and applied the Medicare contract segment definition to IBC.

OIG's Response

Our response is summarized in the following paragraphs. The CMS, Office of the Actuary's detailed response on IBC's comments are presented in Appendix D.

The IBC's arguments completely ignore the terms and underlying principles of their Medicare contract. While IBC's comments cited nearly every section of the segmentation requirements contained in Appendix B of the Medicare contract, they arbitrarily omitted the key section. Additionally, IBC selectively cited paragraphs of the contract out of sequence and presented them as stand alone rules, which they are not.

The CMS incorporated segmentation requirements into Medicare contracts starting with Fiscal Year 1988. The contracts' methodology for establishing the initial Medicare segment assets was negotiated and agreed to by CMS and the Medicare contractors. The objective of the methodology was to fairly represent the events of prior periods. When taken as a whole and followed in order, the Medicare contract sets forth a sequential method of establishing the Medicare segment's initial pension assets.

The segmentation requirements are contained in the Medicare contract, Appendix B, at Item XVI, paragraphs A through D. Paragraph A contains the "Preamble", which requires that the calculation of and accounting for pension costs be governed by the FAR and CAS. Paragraph B contains the definition of the term "Medicare Segment", as cited in the **Background** section of this report and in IBC's comments. Paragraph C requires pension costs of a segment to be separately calculated when such calculation materially affects the amount of pension costs allocated to the segment. Paragraph D includes the identification and allocation of pension assets, and is the paragraph that IBC has partially omitted and completely misinterpreted.

Paragraph D, in its entirety, states:

> "D. Identification and Allocation of Pension Assets: Beginning with the pension plan year starting in fiscal year 1988, the contractor must separately identify pension assets for any Medicare Segment(s), as defined in Paragraph B, whether pension costs for the segment are allocated or are required to be separately calculated in accordance with Paragraph C.

Pension assets shall be initially allocated and separately identified in accordance with the following procedures:

1. Date of the initial asset allocation: The initial asset allocation shall be made as of the later of the first day of the first pension plan year following December 31, 1985, or the first day of the first pension plan year following the date on which a Medicare Segment, as defined in Paragraph B, first existed. The date on which the assets are allocated will be referred to as the "allocation date."

2. Determination of assets allocated to a Medicare Segment: The amount of assets initially allocated to a Medicare Segment shall be determined by multiplying the actuarial value of the undivided pension fund assets on the allocation date by a fraction in which the numerator is the actuarial liability of the segment and denominator is the actuarial liability of the pension plan as a whole (including the segment). This fraction will be referred to as the "asset fraction."

3. Determination of the actuarial liabilities: The actuarial liabilities used in the asset fraction will be the actuarial liabilities, as of the later of the first day of the first pension plan year following December 31, 1980, or the first day of the first pension plan year following the date such Medicare Segment first existed, determined under an immediate-gain actuarial cost method consistent with the cost method which was used to fund the pension plan, as of the date for which the asset fraction is being determined.

4. Determining segment assets following initial allocation: For each pension plan year following the initial asset allocation required by this Item XVI, the pension assets allocated to each Medicare Segment shall be adjusted in accordance with CAS 413.50(c)(7)."

Paragraph D clearly requires contractors to separately identify Medicare segment(s) assets beginning with the pension plan year starting in Fiscal Year 1988. Therefore, paragraph D also requires contractors to first identify their Medicare segment(s) beginning with Fiscal Year 1988. Additionally, subsections of paragraph D (D.1. through D.4.) set forth the methodology to be used in establishing the 1988 segment's initial assets.

In accordance with the contract, we identified the Medicare segment as of July 1, 1988 and traced the segment's organizational lineage back to 1986, and then to 1981. Tracing the segment from 1988 back to 1986 was straight forward as the cost centers were virtually unchanged. It should be noted that our identification of the Medicare segment cost centers for these years was materially the same as IBC's. Additionally, by reviewing documents provided by IBC and through interviews with IBC personnel that were employed in the Medicare segment in 1981, we were able to identify the 1988 segment's organizational component, as it existed on July 1, 1981.

Using this information, we computed the 1981 asset fraction. It should also be noted that the cost centers we identified for purposes of computing the 1981 asset fraction were all included in IBC's original asset fraction calculation.

In IBC's response to CMS's Pension Cost Questionnaire, dated August 30, 1989, IBC identified its Medicare segment as the organizational subdivision known as "Provider Services." At that time, IBC identified 1981 Medicare segment actuarial liabilities as $2,637,000 and total company actuarial liabilities as $28,835,000, resulting in an asset fraction of 9.15 percent. When applied to 1986 total company assets, the Medicare segment's initial assets were $2,517,930.

Subsequent to the contract termination, IBC revised its asset fraction. The revised calculation identified Medicare segment actuarial liabilities as $162,130 and total company actuarial liabilities as $19,748,904, resulting in an asset fraction of 0.82 percent. When applied to 1986 total company assets, the Medicare segment's initial assets were identified as $226,038 (actuarial value of assets).

We found no justification in the reasons IBC gave for revising its asset fraction and initial allocation of pension assets. The IBC said that it revised the 1981 asset fraction and initial allocation of Medicare segment assets because, "…in retrospect, we realized that such a broad definition is virtually unworkable for the type of pension calculations required by the Medicare Contract." The only change that IBC made was in the asset fraction. The IBC did not change their identification of the Medicare segment for any other year. In fact, IBC included cost centers in their identification of the 1986 segment that it deleted from the segment in 1981 for purposes of computing its revised asset fraction. Likewise, IBC did not change any of the pension costs assigned to the Medicare segment for any of the years 1986 through 1997.

The IBC's original identification of the 1981 Medicare segment included 92 participants in 13 cost centers. However, its revised identification of the 1981 Medicare segment included only 20 participants in 2 cost centers. In comparison, IBC's identification of its 1986 Medicare segment included 14 cost centers and 118 participants and as previously noted, IBC did not change its identification of the Medicare segment for any year other than 1981.

The only thing IBC accomplished by revising its asset fraction and initial allocation of Medicare segment assets was to shift a financial obligation from IBC to Medicare. The IBC's Medicare segment had total actuarial liabilities of $2,136,287 as of July 1, 1986. However, based upon IBC's revised asset fraction calculation, the segment was only allocated $226,038 in pension assets. Consequently, the Medicare segment's funding level (ratio of assets to liabilities) was only 10.58 percent. At the same time, the funding level of IBC's total pension plan was 64 percent. Per our asset fraction and initial asset allocation, the 1986 Medicare segment's funding level was 63.5 percent.

We acknowledge that the denominator of our asset fraction was different from IBC's. We used the total company actuarial liability as shown in IBC's 1981 Actuarial Valuation Report as the denominator of our audited asset fraction. The IBC's denominator was based on a revaluation of "reconstructed" 1981 data files, which could not be reconciled to the 1981 Actuarial Valuation

Report. We analyzed IBC's revaluation of the 1981 data and found that it included 36 additional active participants, but omitted 107 inactive participants. We, therefore, determined the revaluation to be invalid, for purposes of the denominator.

We also acknowledge that we applied our asset fraction to the total company market value of assets and computed the update of segment assets using the market value of assets, instead of the actuarial value of assets. However, this point is irrelevant since the actuarial value of assets is based on the market value of assets. Consequently, we would have arrived at the same asset value if we had used the actuarial value of assets in 1986 and in the update of assets, and then converted it to the market value of assets as of September 30, 1997.

Contrary to IBC's contentions, our identification of the Medicare segment was made in accordance with the Medicare contract. Additionally, our identification of the segment cost centers for years 1986 through 1997 was materially the same as IBC's. For 1986 through 1997, we obtained actuarial valuation data files from IBC, which included the participant's cost center number. We identified the segment participants based on our identification of the Medicare segment cost centers, which again was materially the same as IBC's.

For purposes of the segment closing adjustment, IBC identified the segment's actuarial accrued liability as $3,525,418 as of September 30, 1997. However, we computed the segment's actuarial accrued liability as $1,633,091 as of September 30, 1997. Since the amounts were different, IBC concluded that our identification of the segment was incorrect. Additionally, IBC asserted that its identification of the segment as of September 30, 1997 complied strictly with the contract and should be used to perform the segment closing adjustment.

The IBC provided us with a data file showing the details of its calculation of the Medicare segment's actuarial accrued liability as of September 30, 1997. We reviewed that data and found that our calculation of the segment's actuarial accrued liability differed from IBC's calculation for two reasons. First, IBC used a non-compliant method to compute the segment's actuarial accrued liability. Second, IBC incorrectly identified the Medicare segment participants as of September 30, 1997.

Per CAS, the segment's actuarial accrued liability should have been computed using the accrued benefit cost method (ABCM). The CAS at 9904.413-50(c)(12)(i) states:

> "The determination of the actuarial accrued liability shall be made using the accrued benefit cost method. The actuarial assumptions employed shall be consistent with the current and prior long term assumptions used in the measurement of pension costs...."

We determined that IBC had not used the ABCM to compute the segment's actuarial accrued liability as of September 30, 1997. Instead, IBC continued to use a cost method that projects future salaries when determining the liabilities. Consequently, IBC's actuarial accrued liability was overstated. The ABCM removes such projections and determines the present value of the accrued liabilities as of the segment closing date. Our computation of the segment's actuarial accrued liability used the ABCM.

The IBC included 154 participants in its calculation of the accrued actuarial liability as of September 30, 1997. However, there were only 86 participants in our computation. The primary difference between IBC's and our identification of segment participants was due to 64 active participants that we transferred out of the segment at the end of 1996. These 64 participants were not in a Medicare segment cost center on the January 1, 1997 valuation data files. As shown in the **"Participants and Transfers"** section of this report, we transferred assets of $1,302,294 out of the Medicare segment at the end of 1996. The IBC did not compute any transfer adjustment for the end of year 1996. It should be noted that the actuarial accrued liabilities on which our transfer adjustment was based were also computed under the ABCM as required by CAS.

The IBC's identification of the September 30, 1997 segment also included several participants that did not have a vested benefit. The IBC also included several participants that were not Medicare segment participants per the data files provided to us by IBC. On the other hand, IBC's identification of the segment as of September 30, 1997 also omitted several participants that we determined were Medicare segment participants. These misidentified participants were primarily inactive participants. We tracked inactive participants year by year from July 1, 1986 to September 30, 1997. In contrast, IBC attempted to identify them retroactively as of September 30, 1997.

We disagree with IBC's contention that we did not identify our interpretation of the Medicare contract's segment definition. We cited the contract's segment definition in the **"Background"** section of this report. We also described our methodology in the **"Scope"** section of this report. Additionally, during our fieldwork we met with IBC personnel and their legal counsel and discussed our differences regarding the asset fraction calculation. At that time, we provided a detailed explanation of our methodology for identifying the 1981 segment and computing the asset fraction. Subsequently, we provided various documents to IBC that identified that methodology and clearly showed the differences between IBC's and OIG's identification of the Medicare segment.

Certain amounts were revised subsequent to the issuance of our draft report. The amounts presented in this final report reflect those revisions. See Appendix A, Footnote 12 for further details on the revisions.

INSTRUCTIONS FOR AUDITEE RESPONSE

Final determinations as to actions to be taken on all matters reported will be made by the CMS 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 CMS 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, 5 U.S.C. 552, as amended by Public Law 104-231, OIG, OAS reports are made available to the public to the extent information contained therein is not subject to exemptions in the Act. (See 45 CFR part 5). As such, within 10 business days after the final report is issued, it will be posted on the worldwide web at **http://oig.hhs.gov/**.

Sincerely,

James P. Aasmundstad
Regional Inspector General for
Audit Services, Region VII

Enclosures

CMS Action Official:

Ms. Charlene Brown
Regional Administrator, Region III
Centers for Medicare & Medicaid Services
The Public Ledger Building
150 South Independence Mall
Philadelphia, Pennsylvania 19106-3499

INDEPENDENCE BLUE CROSS
CIN: A-07-01-00132

STATEMENT OF MEDICARE PENSION ASSETS

JULY 1, 1986 TO SEPTEMBER 30, 1997

Description		Total Company	Other Segment	Medicare
Asset Fraction, July 1, 1981		**100%**	**95.2255%**	**4.7745%**
Assets as of July 1, 1986	1/	**$33,510,864**	**31,910,888**	**$1,599,976**
Prepayment	2/	0	0	0
Employer Contributions	3/	2,759,155	2,538,111	221,044
Investment Return	4/	4,394,444	4,176,915	217,529
Benefit Payments	5/	(1,298,639)	(1,288,691)	(9,948)
Administrative Expenses	6/	(117,873)	(112,038)	(5,835)
Transfers	7/	0	(4,645)	4,645
Assets as of July 1, 1987		**$39,247,951**	**$37,220,540**	**$2,027,411**
Prepayment		0	(20,295)	20,295
Employer Contributions		1,200,000	1,075,683	124,317
Investment Return		772,902	731,530	41,372
Benefit Payments		(1,619,518)	(1,599,085)	(20,433)
Administrative Expenses		(98,042)	(92,794)	(5,248)
Transfers		0	6,154	(6,154)
Assets as of July 1, 1988		**$39,503,293**	**$37,321,733**	**$2,181,560**
Prepayment		0	0	0
Employer Contributions		0	0	0
Investment Return		5,053,360	4,769,814	283,546
Benefit Payments		(1,803,913)	(1,772,671)	(31,242)
Administrative Expenses		(76,878)	(72,564)	(4,314)
Transfers		0	(90,376)	90,376
Assets as of July 1, 1989		**$42,675,862**	**$40,155,936**	**$2,519,926**
Prepayment		0	0	0
Employer Contributions		1,945,813	1,657,556	288,257
Investment Return		4,145,834	3,892,030	253,804
Benefit Payments		(3,572,383)	(3,538,980)	(33,403)
Administrative Expenses		(160,079)	(150,279)	(9,800)
Transfers		0	154,097	(154,097)
Assets as of July 1, 1990		**$45,035,047**	**$42,170,360**	**$2,864,687**

INDEPENDENCE BLUE CROSS
CIN: A-07-01-00132

STATEMENT OF MEDICARE PENSION ASSETS

JULY 1, 1986 TO SEPTEMBER 30, 1997

Description		Total Company	Other Segment	Medicare
Assets as of July 1, 1990		**$45,035,047**	**$42,170,360**	**$2,864,687**
Prepayment		0	0	0
Employer Contributions		0	0	0
Variance in 7/1/90 MVA	8/	(128,776)	(120,585)	(8,191)
Investment Return		4,710,385	4,402,291	308,094
Benefit Payments		(3,067,380)	(3,028,161)	(39,219)
Administrative Expenses		(361,704)	(338,046)	(23,658)
Transfers		0	28,509	(28,509)
Assets as of July 1, 1991		**$46,187,572**	**$43,114,368**	**$3,073,204**
Prepayment		0	0	0
Employer Contributions		1,148,020	1,065,355	82,655
Investment Return		6,890,943	6,427,057	463,886
Benefit Payments		(1,579,914)	(1,539,914)	(40,000)
Administrative Expenses		(492,162)	(459,031)	(33,131)
Transfers		0	23,129	(23,129)
Assets as of July 1, 1992		**$52,154,459**	**$48,630,974**	**$3,523,485**
Prepayment		0	0	0
Employer Contributions		3,461,984	3,308,701	153,283
Investment Return		6,861,361	6,395,553	465,808
Benefit Payments		(2,002,597)	(1,961,036)	(41,561)
Administrative Expenses		(530,479)	(494,466)	(36,013)
Transfers		0	(58,070)	58,070
Assets as of July 1, 1993		**$59,944,728**	**$55,821,656**	**$4,123,072**
Prepayment		0	(9,057)	9,057
Employer Contributions		1,700,000	1,648,555	51,445
Investment Return		812,324	756,222	56,102
Benefit Payments		(2,679,295)	(2,602,570)	(76,725)
Administrative Expenses		(619,416)	(576,637)	(42,779)
Transfers		0	182,738	(182,738)
Assets as of July 1, 1994		**$59,158,341**	**$55,220,907**	**$3,937,434**

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CIN: A-07-01-00132

STATEMENT OF MEDICARE PENSION ASSETS

JULY 1, 1986 TO SEPTEMBER 30, 1997

Description		Total Company	Other Segment	Medicare
Assets as of July 1, 1994		**$59,158,341**	**$55,220,907**	**$3,937,434**
Prepayment		0	0	0
Employer Contributions		2,990,002	2,955,846	34,156
Keystone Transfer-In	9/	2,178,162	2,178,162	0
Investment Return		1,118,389	1,043,835	74,554
Benefit Payments		(648,785)	(627,614)	(21,171)
Administrative Expenses		(319,495)	(298,197)	(21,298)
Transfers		0	140,633	(140,633)
Assets as of January 1, 1995		**$64,476,614**	**$60,613,572**	**$3,863,042**
Prepayment		0	(38,700)	38,700
Employer Contributions		8,402,834	8,226,526	176,308
Investment Return		13,816,102	12,975,733	840,369
Benefit Payments		(2,671,566)	(2,629,225)	(42,341)
Administrative Expenses		(641,891)	(602,848)	(39,043)
Transfers		0	165,924	(165,924)
Assets as of January 1, 1996		**$83,382,093**	**$78,710,982**	**$4,671,111**
Prepayment		0	(132,795)	132,795
Employer Contributions		452,747	435,745	17,002
Investment Return		11,215,375	10,561,482	653,893
Benefit Payments		(4,206,843)	(4,076,648)	(130,195)
Administrative Expenses		(682,017)	(642,253)	(39,764)
Transfers		0	1,302,294	(1,302,294)
Assets as of January 1, 1997		**$90,161,355**	**$86,158,807**	**$4,002,548**
Prepayment		0	0	0
Employer Contributions		10,011,273	10,011,273	0
Investment Return		17,555,853	16,769,962	785,891
Benefit Payments		(2,444,876)	(2,402,511)	(42,365)
Administrative Expenses		0	0	0
Transfers		0	0	0
Assets as of September 30, 1997		**$115,283,605**	**110,537,531**	**$4,746,074**
Per IBC	10/	**105,272,232**	**104,177,778**	**1,094,454**
Asset Variance	11/	**$10,011,373**	**$6,359,753**	**$3,651,620**

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STATEMENT OF MEDICARE PENSION ASSETS

JULY 1, 1986 TO SEPTEMBER 30, 1997

FOOTNOTES

1. We calculated the Medicare segment assets based on our identification of the Medicare segment and our computed asset fraction (4.7745 percent). We computed the asset fraction as explained in our **Findings and Recommendations** section of the report narrative. The amounts shown for the other segment represent the difference between the total company and the Medicare segment. All pension assets are shown at market value.

2. The prepayment credit is created when the contributions made to the pension trust fund exceed the CAS pension cost. The prepayment remains unassigned and accumulates interest in the trust fund until needed to fund future CAS pension costs. We allocated the prepayment in proportion to the CAS pension costs. The IBC did not compute prepayment credits for contributions in excess of CAS cost.

3. We obtained total contribution amounts from IRS Form 5500 reports. The IBC did not make contributions to the pension trust fund for plan years 1988 and 1990. Additionally, the contributions made for plan years 1996 and 1997 were totally attributable to the "other" segment. Therefore, no portion of these years' contributions was assigned to the Medicare segment

4. We obtained investment earnings from actuarial valuation reports. The IBC allocated their investment earnings based on a weighted value of assets methodology. We used the same methodology.

5. We obtained total benefit payments from actuarial valuation reports. We based the Medicare segment's benefit payments on actual payments to Medicare retirees.

6. We obtained total plan expenses from actuarial valuation reports. The IBC allocated their expenses based on a weighted value of assets methodology. We used the same methodology.

7. We identified participant transfers between segments by comparing annual participant valuation listings provided by IBC. The listings contained the actuarial liability of each participant. Our transfer adjustment considered each participant's actuarial liability and the funding level of the segment from which the participant transferred. We calculated the funding level as the assets divided by the liabilities. If the funding level ratio was greater than one, we transferred assets equal to the participant's liability.

8. The 1990 actuarial valuation report states the 7/1/90 MVA as $45,035,047. However, the 1991 actuarial valuation report lists the 7/1/90 MVA as $44,906,271. The variance

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STATEMENT OF MEDICARE PENSION ASSETS

JULY 1, 1986 TO SEPTEMBER 30, 1997

in the 7/1/90 MVA appears as the subsequent correction of ($128,776) to the 1990 actuarial valuation report's MVA amount.

9. On 1/1/95 Keystone Health Plan East merged into the IBC pension plan. Keystone employees were merged into the total company data files but not included in the Medicare segment.

10. We obtained the total assets as of 9/30/1997 from IBC's update of assets provided by its actuary.

11. The asset variance represents the difference between the OIG calculation of assets as of September 30, 1997 and the assets calculated by IBC's actuary.

12. Subsequent to the issuance of this report in draft, we discovered that the actuarial accrued liability for inactive participants had inadvertently been omitted from our CAS pension cost calculations. We added the inactive participants and recomputed the Medicare segment's CAS pension costs. This revision increased contributions as well as earnings and expenses for the Medicare segment.

    Additionally, during our analysis of IBC's comments to our draft report, we identified two inactive participants that should have been included in the calculation of the Medicare segment's actuarial accrued liability as of September 30, 1997. We included those two participants and increased the segment's actuarial accrued liability for accrued benefits by $62,137 as of September 30, 1997.

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CIN: A-07-01-00132
STATEMENT OF MEDICARE
AGGREGATE PERCENTAGE
JULY 1, 1986 TO SEPTEMBER 30, 1997

YEAR	TOTAL MEDICARE SEGMENT COSTS	MEDICARE SEGMENT MEDICARE COSTS		AGGREGATE PERCENTAGES
1987	$6,587,991	$5,663,468	1/	85.967%
1988	7,392,789	6,813,181		92.160%
1989	9,034,204	7,232,164		80.053%
1990	8,900,870	8,465,835		95.112%
1991	8,179,664	7,500,740		91.700%
1992	7,251,454	7,056,289		97.309%
1993	8,737,131	8,161,179		93.408%
1994	10,207,489	9,774,302		95.756%
1995	10,342,383	10,177,961		98.410%
1996	9,887,632	9,845,575		99.575%
1997	4,813,275	4,775,672		99.219%
	$91,334,882	$85,466,366		93.575%

FOOTNOTE

[1]We obtained the Medicare segment line of business percentages from data provided by IBC.

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November 8, 2001

BY FACSIMILE AND FEDERAL EXPRESS

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

Re: Draft Audit Report Concerning Independence Blue Cross;
CIN Nos. A-07-01-00132 and A-07-01-03003

Dear Mr. Aasmundstad:

Independence Blue Cross ("IBC"), through its undersigned counsel, hereby responds to the referenced draft Audit Reports. IBC appreciates the opportunity to respond. We also appreciate the additional information your Office has provided since issuing the draft Reports.

We have reviewed the draft Audit Reports and the additional information your Office has provided. After reviewing this information, IBC sees no basis to depart from the calculations it provided to your Office in September 1999, including the initial asset fraction calculation, the asset "roll-up," and the funded status as of September 30, 1997. Therefore, to the extent there are differences between those calculations and information in the draft Reports, IBC disagrees with those aspects of the draft Reports. Also, as discussed below, IBC disagrees with certain fundamental aspects of the draft Reports that likely impact all or many of the calculations in those Reports.[1]

As you know, IBC has previously provided your Office with substantial amounts of data relating to IBC's pension plan. However, if this response raises further questions, please do not hesitate to contact me. Also, as you will see below, IBC cannot discern the basis for certain aspects of the draft Reports, and we would be interested in discussing these items further with your Office. IBC would like to maintain a dialogue with your Office concerning the issues covered by these Reports, including attempting to resolve informally all open issues.

We first address Draft Audit Report A-07-01-00132, "Audit of the Pension Plan at a Terminated Medicare Contractor" ("Termination Report"), before turning to Draft Audit Report A-07-01-03003, "Review of Pension Costs Claimed for Medicare Reimbursement" ("Pension Cost Report").

I. <u>Termination Report</u>

A. <u>Background</u>

Following the termination of IBC's Medicare Intermediary Contract ("Contract") in 1997, IBC performed certain calculations relating to its pension plan in accordance with Cost Accounting Standard ("CAS") 413 and the Contract. The Contract stated that the "calculation of and accounting for pension costs charged to this agreement/contract are governed by the Federal Acquisition Regulation and [CAS] 412 and 413. The Secretary and the contractor agree that, for purposes of this agreement/contract, CAS 413 shall be interpreted and applied as specified herein." Contract, Appendix B, § XVI.A. CAS 413.50(c)(12) states in part:

> If a segment is closed, if there is a pension plan termination, or if there is a curtailment of benefits, the contractor shall determine the difference between the actuarial accrued 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 difference between the market value of the assets and the actuarial accrued liability for the segment represents an adjustment of previously-determined pension costs.

1 This response does not specifically address every detail in the draft Audit Reports, and this fact should not be construed as an acceptance of any part of the Reports or a waiver of any IBC right(s). IBC reserves all rights with respect to the draft Audit Reports.

Determining the difference between the market value of the assets and the actuarial accrued liability pursuant to CAS 413.50(c)(12) required performing other calculations, including an initial asset allocation. The Contract set forth the methodology for this allocation:

> Pension assets shall be initially allocated and separately identified in accordance with the following procedures:
>
> 1. Date of the initial asset allocation: The initial asset allocation shall be made as of the later of the first day of the first pension plan year following December 31, 1985, or the first day of the first pension plan year following the date on which a Medicare Segment, as defined in Paragraph B, first existed. The date on which the assets are allocated will be referred to as the "allocation date."
>
> 2. Determination of assets allocated to a Medicare Segment: The amount of assets initially allocated to a Medicare Segment shall be determined by multiplying the actuarial value of the undivided pension fund assets on the allocation date by a fraction in which the numerator is the actuarial liability of the segment and the denominator is the actuarial liability of the pension plan as a whole (including the segment). This fraction will be referred to as the "asset fraction."

Contract, Appendix B, § XVI.D. Pursuant to this provision, the date of the initial asset allocation is July 1, 1986. The Contract also specified the date for determining the asset fraction's actuarial liabilities:

> The actuarial liabilities used in the asset fraction will be the actuarial liabilities, as of the later of the first day of the first pension plan year following December 31, 1980, or the first day of the first pension plan year following the date such Medicare Segment first existed, determined under an immediate-gain actuarial cost method consistent with the cost method which was used to fund the pension plan, as of the date for which the asset fraction is being determined.

Contract, Appendix B, § XVI.D.3. The appropriate date for determining the asset fraction liabilities is July 1, 1981.

The Contract included a provision for determining segment assets following the initial asset allocation (also known as the asset "roll-up"): "For each pension plan year following the initial asset allocation required by this Item XVI, the pension assets allocated to each Medicare Segment shall be adjusted in accordance with CAS 413.50(c)(7)." *Id.*, Appendix B, § XVI.D.4. CAS 413.50(c)(7) states in part: "After the initial allocation of assets, the contractor shall maintain a record of the portion of subsequent contributions, permitted unfunded accruals, income, benefit payments, and expenses attributable to the segment and paid from the assets of the pension plan . . . ."

After the Contract termination, IBC performed work necessary to calculate the difference between assets and liabilities pursuant to CAS 413.50(c)(12), including identifying the "Medicare segment" and the asset fraction in accordance with the Contract. In correspondence with HCFA in 1989, IBC referred to the Medicare segment as the organizational subdivision known as "Provider Services." Following the termination, IBC reviewed this matter. As discussed in previous correspondence with your Office, IBC found that definition to be problematic because a large number of people who did not perform work on the Medicare Contract were included within the segment. Also, in retrospect, IBC realized that such a broad definition is virtually unworkable for the type of pension calculations required by the Contract. Because it was necessary to recreate the initial asset allocation and the asset roll-up, IBC determined that the use of an appropriate but more manageable Medicare segment was prudent. For purposes of recreating an appropriate segment, and performing an initial asset allocation and a yearly asset roll-up, IBC redefined the 1981 Medicare segment to include a smaller, more appropriate group of participants. As discussed further below, the revised definition strictly complies with the Contract's definition of "Medicare segment."

IBC produced to your Office voluminous data relating to its post-termination efforts in support of the subject audit. This data included results of the calculations performed in accordance with CAS 413.50(c)(12) and the Contract. In September 1999, IBC forwarded to your Office these results. IBC identified the asset fraction as 0.82096%, based on July 1, 1981 segment liability of $162,130 divided by July 1, 1981 plan liability of $19,748,904. IBC also identified the July 1, 1986 actuarial value of the undivided pension fund assets as $27,533,485; this amount multiplied by the asset fraction yields $226,038 – the amount of assets initially allocated to the segment. IBC provided your Office with its "roll-up" of the segment actuarial value of assets from July 1, 1986 to September 30, 1997. Finally, IBC provided the Government with the following calculation, performed pursuant to CAS 413.50(c)(12), reflecting the segment's funded status as of September 30, 1997:

Market Value of Assets	$ 1,094,454
Actuarial Accrued Liability	3,525,418
Funded Status	$(2,430,964).

The Termination Report focuses on IBC's calculations and states that the purpose of the Government's review "was to evaluate [IBC's] compliance with the pension segmentation requirements of its Medicare contract and to determine the excess assets that should be remitted to Medicare as a result of the termination of the Medicare contractual relationship effective

September 30, 1997." Termination Report at 1. The Report disagrees with IBC's calculations, and asserts that IBC's Medicare segment assets exceeded the segment's actuarial accrued liability by $2,496,731. After applying a "Medicare percentage" of 93.58% to this amount, the Report recommends that IBC "[r]efund $2,336,441 of excess Medicare pension assets resulting from the termination of its Medicare contract to the CMS." *Id.* at 9-10.

B. The Asset Fraction

One of the main reasons for the differences between IBC's and the Termination Report's CAS 413.50(c)(12) calculations is the Government's use of a larger asset fraction, which in turn contributed to the Government's use of a larger initial asset base for purposes of updating the Medicare segment assets.[2] We provide an overview of steps involved in determining the asset fraction and initial asset allocation to underscore the fact that these calculations are dictated by the Contract.

First, as discussed above, the Contract provided that the asset fraction consists of (1) a numerator – the actuarial liability of the Medicare segment, and (2) a denominator – the actuarial liability of the pension plan as a whole (including the segment). Contract, Appendix B, § XVI.D.2. Second, the Contract specified the date for determining these two actuarial liabilities, which was July 1, 1981. *See id.*, Appendix B, § XVI.D.3. Third, the Contract required that the initial asset allocation be determined by multiplying the actuarial value of the pension fund assets on the contractually-specified "allocation date" (July 1, 1986) by the asset fraction. *See id.*, Appendix B, § XVI.D.

There are significant differences between IBC's calculations and the calculations in the Termination Report. With respect to the denominator of the asset fraction, the Government actually arrived at a larger figure than IBC – $20,327,543 compared to $19,748,904 – which would result in a *smaller* asset fraction if the numerators were the same. However, the numerators were not the same. IBC calculated the 1981 Medicare segment's actuarial liability to be $162,130, while the Government arrived at a figure of $970,526. Thus, IBC's asset fraction was 0.82096% ($162,130 ÷ $19,748,904) while the Government's fraction was 4.7745% ($970,526 ÷ $20,327,543). Also, the Termination Report applies its fraction to the *market value* of 1986 total Company assets – $33,510,864 – yet the Contract required multiplying the fraction and the *actuarial value* of the undivided pension fund assets on the allocation date (July 1, 1986).

[2] The Termination Report recognizes the significance of the parties' different asset fractions, which resulted in different initial asset bases. *See* Termination Report at 5 ("We increased the asset fraction from 0.82096 percent to 4.7745 percent by including the missing participants. Our calculations increased the Medicare segment assets by $1,324,865 to $1,599,976."); *see id.* at 6 ("IBC's methodology in updating the Medicare segment assets from July 1, 1986 to September 30, 1997 resulted in an understatement of Medicare segment assets of $1,788,041. *This understatement primarily occurred because IBC started the update with an understated asset base for 1986.*") (emphasis added).

Contract, Appendix B, § XVI.D.2. As set forth in IBC's September 1999 submission, the 1986 actuarial value of the undivided pension fund assets is $27,533,485. We do not know why the Termination Report used the market value of the 1986 assets.

The results of these calculations are summarized below (this format is similar to the comparison at page 5 of the Termination Report, except that the Report substitutes the market value of the 1986 assets for the actuarial value of those assets in IBC's calculation):

	1981 Total Actuarial Liability (A)	1981 Medicare Actuarial Liability (B)	1981 Rounded Asset Fraction (C)=(B)/(A)	1986 Total Company Assets (D)	1986 Medicare Segment Assets (E)=(C)(D)
OIG Calculation	$20,327,543	$970,526	4.7745%	$33,510,864	$1,599,976
IBC Calculation	$19,748,904	$162,130	0.82096%	$27,533,485	$226,038

The different numerators (1981 segment liability) are the primary reason for the different initial asset allocations, and ultimately the different assets used in the CAS 413.50(c)(12) calculation. The parties arrived at different numerators because they disagree on what constitutes IBC's Medicare segment in 1981. We explain below (at § E) why IBC's determination of the Medicare segment complies with the Contract and should be used in the specified calculations.

C. <u>Asset "Roll-Up"</u>

As noted above, the Contract required that the asset roll-up be performed, for each year after the initial allocation, in accordance with CAS 413.50(c)(7). IBC's roll-up was performed in accordance with CAS 413.50(c)(7). The roll-up also was performed based on IBC's definition of the Medicare segment (discussed further below), which strictly complies with the Contract. In September 1999, IBC provided your Office with the roll-up of the Medicare segment's actuarial value of assets from July 1, 1986 to September 30, 1997. IBC's roll-up established that the actuarial value of the assets as of September 30, 1997 was $954,780. As noted in IBC's September 1999 submission, the market value of the segment assets was determined by multiplying the market value of total plan assets on September 30, 1997 by the ratio of the actuarial value of the segment assets as of September 30, 1997 to the actuarial value of the total plan assets on September 30, 1997. The specific numbers used for this calculation are:

$$\$105{,}272{,}332 \times \frac{954{,}780}{91{,}837{,}472} = \$1{,}094{,}454.$$

The Termination Report contains information concerning the Government's asset roll-up, and states: "Our calculation showed that assets of the Medicare segment increased $3,112,906 to

$4,067,686 as of September 30, 1997." Termination Report at 9. The difference between the Government's asset roll-up and IBC's roll-up results primarily from the parties' different initial asset allocations. Also, we assume that the Government relied on some definition of the Medicare segment to identify participants for purposes of performing its asset roll-up. Unfortunately, as discussed further below, the Report does not identify the Government's interpretation of the Contract segment definition or how the Government applied that definition to IBC. Furthermore, the workpapers and other documents produced by your Office do not discuss the Government's interpretation or application of the Contract's segment definition.[3]

D. Actuarial Accrued Liability as of September 30, 1997

IBC provided your Office with the segment's actuarial accrued liability as of September 30, 1997 – $3,525,418 – as well as supporting details, with its September 1999 submission. In order to identify properly the actuarial accrued liability, IBC identified the Medicare segment for the years 1986 through 1997. IBC identified the segment in accordance with its definition of the Medicare segment (discussed further below), which strictly complies with the Contract.

With respect to accrued liability, the Termination Report states simply: "We computed the Medicare actuarial accrued liability for accrued benefits to be $1,570,955." Termination Report at 9. Information provided by your Office indicates that the difference in the parties' respective accrued liability figures results from identifying different segment populations as of September 30, 1997. Presumably, the Government relied on a definition of the Medicare segment to identify participants for purposes of calculating liability as of September 30, 1997, but the Termination Report and the information provided by your Office do not identify the Government's interpretation of the Contract segment definition or how the Government applied that definition to IBC.

E. The Medicare Segment

The calculations in IBC's September 1999 submission to your Office were performed in accordance with the Contract and applicable CAS requirements. These calculations required

[3] The Termination Report indicates that "IBC's methodology in updating the Medicare segment assets . . . resulted in an understatement of Medicare segment assets of $1,788,041." Termination Report at 6. We are unable to determine the source for the $1,788,041 figure. Also, we should note that the $3,112,906 figure identified at page 6 of the Report ("[w]hen considered with the 1986 adjustment, IBC understated Medicare pension assets by $3,112,906") appears to be the difference between the Government's *market value* of assets as of September 30, 1997 ($4,067,686) and IBC's *actuarial value* of assets as of that date ($954,780). *See* Termination Report, Appendix A at p. 3 of 5.

identifying the Medicare segment.[4] The parties' different determinations of the segment account in large part for their different CAS 413.50(c)(12) calculations. As discussed further below, we cannot discern the basis for the Government's identification of the segment, while IBC's segment determination complies strictly with the Contract and should be used to perform the required calculations.

1. <u>The Contract Definition</u>

The determination of what constitutes the Medicare segment is dictated by the following definition of "Medicare segment" in the Contract:

> The term "Medicare segment" shall mean 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. The 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.
>
> In those cases in which a Medicare Segment as defined in this paragraph B includes both Medicare and non-Medicare activities, the contractor may, but is not required to, treat just the Medicare portion of the segment as a Medicare Segment for purposes of the calculations described in this Item XVI.
>
> Other organizational components identifiable with purposes common to both the Medicare agreement/contract and the contractor's other lines of business will continue to have pension costs indirectly allocated to the Medicare agreement/contract.

Contract, Appendix B, § XVI.B.

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[4] The Termination Report acknowledges the importance of the "segment" to the required calculations: "To determine Medicare's share, it was necessary to (1) establish the Medicare *segment's* initial pension assets as of July 1, 1986, (2) update the *segment* assets to September 30, 1997, and (3) calculate the actuarial accrued liability for accrued benefits for the *segment*, and the excess Medicare assets." Termination Report at 4 (emphasis added).

2. IBC's Segment Identification Complies With The Contract

IBC's identification of the Medicare segment clearly complies with the Contract definition. IBC identified the segment as any cost center for which more than 50% of the cost center's salary costs were attributable to the Medicare Contract. There should be little debate that a cost center is an "organizational component," and that identifying more than 50% of the salary costs attributable to the Contract is the same as "the majority of the salary dollars . . . allocated to the Medicare agreement/contract." As such, IBC's identification of the Medicare segment complies with the Contract.

In addition, IBC properly identified the cost centers in 1981 for purposes of calculating the asset fraction. As discussed in previous correspondence with your Office, the three cost centers in 1981 were: 66223 (Medicare I), 77500 (Medicare Coordinator), and 77202 (Provider Audit – Medicare). IBC has previously provided your Office with a 1981 Final Administrative Cost Proposal ("FACP") containing details that support this identification. IBC understands that the Government has audited and approved this FACP. The Termination Report does not mention this FACP.

3. The Termination Report Does Not Identify The Government's Interpretation, How The Government Applied That Interpretation To IBC, Or Why IBC's Determination Does Not Comply With The Contract

The Termination Report does not attempt to explain why IBC's definition of "Medicare segment" fails to comply with the Contract. Moreover, the Report appears to apply a different interpretation of "Medicare segment" without specifically identifying this interpretation. For example, with respect to the asset fraction calculation, the Report states:

> IBC omitted certain cost centers from its 1981 asset fraction calculation. However, IBC included these same cost centers in its identification of the Medicare segment for 1986. *We determined that these cost centers, containing 73 participants, met the contractual specifications for a segment* and included the cost centers in our asset fraction calculation.

Termination Report at 5 (emphasis added). While the Report reflects the Government's *conclusion* that additional cost centers met the Contract's definition, it does not explain *how* the Government reached that conclusion. In particular, the Report does not explain how the Government interpreted the Contract, how the Government applied that interpretation to specific cost centers, how that interpretation differs from IBC's definition, or why the Government's identification of the segment should be substituted for *IBC's* definition of an *IBC* segment.

The Report suggests that IBC's identification of the 1981 segment for purposes of determining the asset fraction is somehow affected by the inclusion of additional cost centers in a *1986* identification of the segment. However, the 1986 segment is irrelevant to identifying the

1981 segment for purposes of determining the asset fraction. The Contract required that the segment's liabilities be identified in *1981*. As such, the status of the segment five years later plays no role under the Contract in calculating the asset fraction.

As with the asset fraction, the Termination Report refers to the "segment" in addressing other parts of the required calculations but does not identify how the Government interpreted and applied the Contract's segment definition. Examples of such references in the Report include:

- "Due to the incorrect identification of the Medicare segment participants, IBC's update of the segment assets did not properly identify benefit payments to retirees that were segment participants. We identified the actual benefits paid to the retirees from the Medicare segment and assigned these costs to the Medicare segment." Termination Report at 6.

- "In the update of pension assets, IBC misidentified Medicare segment participants. . . . We corrected the identification of the segment participants and transfer amounts in updating the Medicare segment pension assets . . . ." *Id.* at 7.

After reviewing the Termination Report, we asked your Office for information relating to the Government's segment identification. Initially, we asked for "all information relating to the conclusion in the report that [IBC] omitted 8 Medicare cost centers (containing 73 participants) from the Medicare segment, including all information concerning the identities of the 8 cost centers, as well as the 73 participants, *and the basis for the conclusion*." (Emphasis added). We also asked for copies of all worksheets supporting numbers and calculations in the Report. In response to these requests, your Office provided a CD containing various documents, including information concerning cost centers (*e.g.* Government "crosswalks"), but no narrative explanation of how the Government interpreted the Contract's definition of "Medicare segment," and no explanation of the basis for the Government's conclusion that eight additional cost centers met that definition.

As such, we again sought information underlying the Termination Report's comments concerning the Medicare segment. In an October 12, 2001 letter, we asked for a description of "how your Office applied the Medicare segment definition from the Medicare contracts . . . to IBC in determining that additional cost centers met this definition for purposes of the 1981 asset fraction calculation." In response, your Office did not describe how it applied the Contract segment definition to IBC, but instead referred to certain documents: "See copy of FAX addressed to Ron Solomon from IBC, file on CD titled 'Interview with 1981 Staff', file on CD titled 'Meeting with IBC Controller', file on CD titled 'IBC's Crosswalk', and Scope section of our audit report." In our October 12 letter, we also asked for a description of how your Office "applied the Medicare segment definition from the Medicare contracts to IBC in determining that additional cost centers met this definition for 1986 and later years (including determinations concerning transfers into and out of the segment)." In response, your Office did not provide the requested description, but again referred to certain documents – two "crosswalks" and the "FAX addressed to Ron Solomon from IBC." Unfortunately, none of these documents describes the Government's interpretation of the Contract definition, the application of that interpretation to IBC, or the basis for any Government disagreement with IBC's identification of the 1981 segment.

The only document identified that provides any insight into *how* the Government selected additional cost centers is a Government summary of a January 24, 2000 meeting with IBC representatives (entitled "Meeting With Controller"). This document includes the following comment by a Government representative:

> We don't agree that your asset fraction is in compliance with the contract. We followed the methodology that we've been using since the very first Medicare segmentation audit in identifying the 1981 Medicare segment. We started with 1988 and traced the segment's lineage back to 1986 and then to 1981. Using this methodology we identified 10 cost centers that should have been included in the asset fraction. [Showed IBC personnel our cross walk of Medicare segment cost centers]. Using this identification of the Medicare segment, we computed an asset fraction of 4.9%.

While this comment mentions a "methodology" that apparently involves tracing the segment's lineage from 1988 to 1981, it does not explain that methodology further, nor does it explain how that methodology complies with the Contract. In particular, it does not explain how the status of the segment in 1986 or 1988 is relevant given the Contract's mandate to focus solely on the segment in 1981 for purposes of the asset fraction. Also, while the referenced excerpt states that the Government did not agree that IBC's asset fraction complies with the Contract, it does not explain the basis for that conclusion or why the Government's segment identification should be substituted for IBC's definition of an IBC segment.

The "Meeting With Controller" document also suggests that the Government may perceive certain "inequities" in IBC's calculation of the asset fraction. In particular, the document includes the following Government comments:

- "In 1986 you had a segment of 118 participants with AAL of about $2.1 million, yet your revised asset fraction was based on only 20 participants in 2 cost centers, resulting in segment assets of only $226,038. Does this seem equitable to you?"
- "This revised asset fraction when applied to total company assets as of 7/1/86 resulted in Medicare segment assets of $226,038. Under IBC's revised computations, the Medicare segment's funding level was only

> 11% as compared to a total company funding level of 64%. Clearly not an equitable distribution of funding."[5]

To the extent these comments reflect current Government concerns, we should note that they are not relevant to the determination of the asset fraction. As discussed above, the Contract clearly required calculation of the Medicare segment liabilities in 1981, and therefore the status of the segment in 1986 is not part of the required equation. Similarly, a comparison of the segment's funding level to the total company funding level is simply not part of the Contract's formula. The Contract sets forth a straightforward method for determining initial segment assets, and there is no basis for altering that method. Indeed, we should note that the Government drafted the provisions requiring the determination of assets; IBC simply followed the method set forth in these provisions.

IBC's determination of the Medicare segment complies with the Contract and should be used to perform the required calculations. The Termination Report offers no reason why IBC's determination does *not* comply with the Contract. Instead, the Report concludes that certain omitted cost centers met the Contract's segment definition, but fails to explain this conclusion. Yet even assuming the Report had explained how the Government's segment determination complies with the Contract, that would not justify supplanting IBC's compliant determination. Designating what constitutes a "segment" under CAS 413 generally is the responsibility of the contractor. *See* 1 Lane K. Anderson, *Accounting for Government Contracts: Cost Accounting Standards* § 22.05[1] (2001) ("The contractor is responsible for designating organizational units as segments, in accordance with the requirements of CAS 403.").

II. Pension Cost Report

A. Background

In conjunction with the termination audit, your Office conducted an audit to determine the allowability of pension costs claimed for FYs 1987 through 1997. Pension Cost Report at 2. Your Office concluded that IBC "under claimed allowable Medicare pension costs" in the amount of $711,444. *Id.* at 1. The Report states that the "under claim of pension costs primarily occurred because IBC neglected to include certain pension contribution amounts on their [FACPs]." *Id.* The Report further states:

> IBC assigned pension costs to Medicare based upon an allocation of actual contributions to its pension trust fund. However, IBC only included an

[5] The "Meeting With Controller" document attributes statements and actions to IBC representatives. IBC does not necessarily agree with these statements/actions, and reserves the right to address further the contents of this document.

> allocable portion of the contributions that were actually deposited at the time the FACPs were filed each year. Consequently, IBC did not claim Medicare reimbursement for any portion of the pension contributions that were deposited after the FACPs were filed. Additionally, due to budget constraints, IBC did not file supplemental or amended FACPs to include the additional pension contributions made after the original filings.

Id. at 3.

As with the Termination Report, the Pension Cost Report appears to rest substantially on the Government's identification of the Medicare segment: "We calculated the allowable CAS pension costs *for the Medicare segment* and for Medicare indirect operations. The calculations were based on separately computed CAS pension costs *for the Medicare segment* and total company CAS pension costs." *Id.* (emphasis added). However, as discussed below, the Pension Cost Report does not identify *how* the Government interpreted the Contract's segment definition or applied that interpretation to IBC in determining allowable costs.

B. The Government's Conclusions Appear To Be Based On An <u>Unidentified Interpretation Of The Contract's Segment Definition</u>

After receiving the Pension Cost Report, we asked your Office (in our August 29 letter) for "[c]opies of all worksheets that support the numbers and calculations in the [Termination and Pension Cost] reports. . . ." We have reviewed the information produced, but cannot discern which specific contributions the Government believes IBC did not claim "that were deposited after the FACPs were filed."

More importantly, we cannot discern how the Government interpreted the Contract segment definition and applied that interpretation to IBC. As noted earlier, it appears that the Government's identification of the segment is an important factor in the Pension Cost Report's conclusions. We suspect that the Government's segment identification was substantially the same as the identification used in the Termination Report. Indeed, we suspect that the Government's redetermination of IBC's segment identification used in performing the required termination calculations likely led to and significantly influenced the Government's separate pension cost calculations. However, we cannot confirm the details underlying the Government's pension cost calculations.

To the extent that IBC did not claim Medicare reimbursement for pension contributions that were deposited after IBC filed its FACPs, and those costs are allowable under IBC's identification of the Medicare segment, IBC agrees that such costs would be reimbursable. However, to the extent the Government arrived at any portion of the allowable costs in the Pension Cost Report based on a different identification of the segment, IBC reserves the right to contest the Report's conclusions. As stated in response to the Termination Report, IBC's determination of the segment complies with the Contract and should be used to perform the required calculations. Neither the Termination Report nor the Pension Cost Report offers any reason why IBC's determination does *not* comply with the Contract, and neither explains how the Government interpreted the Contract definition or applied that interpretation to IBC.

III. Conclusion

Let me reiterate our appreciation of the information provided by your Office in connection with the Audit Reports. Based on the Reports and supporting data, the definition of "Medicare segment" appears to influence significantly the Government's conclusions and also appears to be the primary difference between the parties. IBC believes that its identification of the segment strictly complies with the Contract and should be used in performing the required calculations and determining allowable costs. We cannot discern the basis for Government's segment identification, but would be willing to discuss this matter further with your Office. As I mentioned earlier, IBC is interested in maintaining a dialogue with your Office and attempting to resolve informally all open issues.

Thank you again for your continuing cooperation. Please let me know if you have any questions or comments.

Sincerely,

Marcia G. Madsen

Marcia G. Madsen

cc: Greg Tambke
Eleanor Thompson

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Office of the Actuary
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MEMORANDUM

To: Greg Tambke, Audit Manager
HHS/OIG/OAS, Jefferson City, Missouri

From: Ron Solomon

Date: November 19, 2001

Subject: Analysis of Segment Identification by Independence Blue Cross (IBC)

This memorandum reviews the segment identification issues raised in the 14 page response submitted by IBC to the two pension draft audit reports (CIN A-07-01-00132 Audit of the Pension Plan at a Terminated Medicare Contractor Independence Blue Cross and CIN A-07-01-03003 Review of Pension Costs Claimed for Medicare Reimbursement by Independence Blue Cross) via counsel on November 8, 2001. Notwithstanding the detailed reasons for the recommendations set forth in the reports, IBC essentially disagrees with any finding that is not consistent with the calculations it provided to the auditors in September, 1999. In the response, IBC states that it "disagrees with certain fundamental aspects of the draft Reports that likely impact all or many of the calculations in those Reports." Those fundamental aspects are the identification of the Medicare segment in accordance with the contract, and the subsequent determination of the asset fraction and the initial allocation of assets to the segment. Even though IBC recognizes the fundamental nature of the segment identification (1), it does not get around to a discussion of this issue until Section I.E, beginning on page 7.

IBC uses virtually all of page 8 of its response to quote the Medicare contract, Appendix B, §XVI.B, regarding the determination of the Medicare segment. Appendix B §XVI was added to the Medicare contract effective October 1, 1987 following extensive negotiations (2). As of that time each contractor was required to identify its Medicare segment(s) if any ("any organizational component of the contractor…having a significant degree of responsibility and accountability for the Medicare contract/agreement…"). The contractors were all notified by letter in early 1989 of the need to comply with Appendix B §XVI of the contract. The letter,

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1 In addition to the quote above from the second paragraph of the response, segment identification is referenced in Sections I.A, I.B, I.C, and I.D prior to the discussion in I.E.
2 IBC incorrectly asserts on page 12 of its response that "the Government drafted the provisions…" In reality, the language of Appendix B §XVI was jointly developed by HCFA and contractor representatives and their attorneys.

which IBC received in April, 1989, was accompanied by a questionnaire which outlined the process contractors were to follow and also specified relevant documentation that was necessary to be maintained by the contractor. IBC responded by letter dated August 30, 1989, identifying its Medicare segment as "Provider Services" which "performs all the major Medicare processing activities including: bills payment, appeals, medicare (sic) secondary payer, medical review, audit and provider reimbursement." The letter also stated, "As per your request, documentation supporting all calculations in the questionnaire is on file in our offices and will be periodically updated as new pension related information becomes available."

As noted above, the identification of the Medicare segment is fundamental, because the initial allocation of assets and the determination of the asset fraction are *for the segment*. The contract, which IBC quotes accurately but applies selectively and inaccurately, requires that the initial asset allocation be made to "a Medicare Segment, as defined in Paragraph B" based on a fraction determined for "such Medicare Segment." Thus, it is necessary to take the identified segment as of October 1, 1987 and trace it back to the relevant dates which are, as IBC correctly notes in §I.A of its response, July 1, 1986 and July 1, 1981 respectively. This is what has been done in each and every Medicare contractor pension segmentation audit, and it is what was done in this audit and upon which all calculations are based. It is apparently also what IBC did when responding in 1989.

However IBC completely misapplied the contract language in its 1999 determination and in its current response. Instead of complying with the contractual provisions, IBC wants to define a different segment at each different date. As the response states in §I.A, "Because it was necessary to recreate the initial asset allocation and the asset roll-up, IBC determined that the use of an appropriate but more manageable Medicare segment was prudent. For purposes of recreating an appropriate segment,...IBC *redefined the 1981 Medicare segment* to include a smaller, more appropriate group of participants" (emphasis added). IBC somehow misconstrues the contractual requirement to determine the actuarial liability of the segment in 1981 as requiring a redefinition of the segment in 1981. The response explicitly states this misconception in §I.E.3: "However, the 1986 segment is irrelevant to identifying the 1981 segment for purposes of determining the asset fraction. The Contract required that the segment's liabilities be identified in *1981*" (emphasis in original). Somehow IBC interprets "segment's liabilities be identified" to mean "segment be identified."

IBC in its response even shows that it does not understand the contractual definition of Medicare segment by stating in §I.E.2, "IBC identified the segment as any cost center for which more than 50% of the cost center's salary costs were attributable to the Medicare Contract." Only by ignoring the additional language in the contract quoted above about an organizational component with a significant degree of responsibility and accountability can IBC identify this collection of cost centers as a segment. It is the contractor's prerogative to establish its organizational structure as it sees fit, and that structure determines the segment, in accordance with the Cost Accounting Standards and the contract. This does not mean that the contractor can decide arbitrarily at some later time to designate a few separate cost centers to be a segment (3). Whether or not a contractor omits the non-Medicare portion of its segment (4), an organizational component constituting a Medicare segment normally does not have 100% of its costs allocated to Medicare. The audit report recommendation reflects the fact that the segment is not 100% Medicare by adjusting the difference between the segment's assets and actuarial liability by the appropriate percentage. The details of this calculation are shown in Appendix B of the report.

To summarize, IBC's response is correct in recognizing that identification of the Medicare segment is fundamental to virtually all of the calculations in the reports. However, IBC's 1999 determination of different Medicare segments at the various dates is not based on contractual provisions, whereas all calculations in the reports are based on the Medicare segment that has been determined in accordance with a strict application of the language in the contract.

Please feel free to contact me at 410-786-6383 or Eric Shipley at 410-786-6381 if you have any questions.

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3 Indeed, it was made clear during the contract negotiations when the contractor representatives and HCFA reached agreement on the specific language of Appendix B §XVI that the contractors did not want segments to be identified at the cost center level based on the percentage of costs charged to the contract by individual cost centers.

4 The contract provides that a contractor having a segment with "both Medicare and non-Medicare activities…may, but is not required to, treat just the Medicare portion of the segment as a Medicare Segment…"