

**Memorandum**

NW 61996

Date

*Michael Mangano*

From

for June Gibbs Brown  
Inspector General

Subject

Post Retirement Benefit Costs Claimed by Blue Cross and Blue Shield of Michigan  
(A-07-96-01 177)

To

Bruce C. Vladeck  
Administrator  
Health Care Financing Administration

This is to **alert** you to the issuance of our **final report** on November 8, 1996-**identifying** almost \$9 million in post retirement costs at Blue Cross Blue Shield of Michigan (Michigan) which were unallowable. A copy is attached and copies of the report have been distributed to your staff for adjudication of the finding.

Michigan's contractual relationships under Medicare were terminated in 1994. In August 1995, Michigan claimed almost \$9 million in post retirement costs estimated to be incurred after termination of the Medicare contracts. We determined that the claim represented a retroactive change in the basis of accounting and a request for reimbursement of unfunded costs. The Federal Acquisition Regulations do not allow for such a retroactive change in accounting basis nor the reimbursement of unfunded costs. Therefore, the post retirement cost of \$9 million are unallowable for Medicare reimbursement and we are recommending that the claim be denied.

Michigan disagreed with our recommendation because they believed that the costs would have been allowable if the contract had continued until the costs were funded. However, the Health Care Financing Administration, Office of the Actuary, reviewed our report, which included Michigan's comments and agreed with our analysis and resultant recommendation.

We will be working with your staff to resolve the complicated issues addressed in this report. If you need additional information about this report, please call me or your staff may contact Barbara A. Bennett, Regional Inspector General for Audit Services, Region VII, (816) 426-3591.

Attachment

**Department of Health and Human Services**

**OFFICE OF  
INSPECTOR GENERAL**

**POST RETIREMENT BENEFIT COSTS  
CLAIMED BY  
BLUE CROSS AND BLUE SHIELD OF MICHIGAN**



**JUNE GIBBS BROWN  
Inspector General**

NOVEMBER 1996  
A-07-96-01177



Region VII  
601 East 12th Street  
Room 284A  
Kansas City, Missouri 64106  
CIN: A-07-96-01 177

Mr. J. Michael Clyne  
Manager, Customer Audit Services  
Blue Cross and Blue Shield of Michigan  
600 Lafayette East #1014  
Detroit, Michigan 48226

Dear Mr. Clyne:

This report provides you with the results of an Office of Inspector General (**OIG**), Office of Audit Services (**OAS**) review titled *Post Retirement Benefit Costs Claimed by Blue Cross and Blue Shield of Michigan*. The purpose of our review was to determine the allowability of \$8,979,998 in post retirement benefit (Post Retirement) costs claimed for Medicare reimbursement by Blue Cross and Blue Shield of Michigan (Michigan). The \$8,979,998 represents Post Retirement costs that will be incurred subsequent to the termination of Michigan's Medicare contracts. The review showed that the claimed costs are **unallowable** for Medicare reimbursement and we recommend that Michigan withdraw the claim.

Michigan disagrees with our recommendation and maintains that the Health Care Financing Administration (**HCFA**) is responsible for reimbursing Post Retirement costs attributable to Michigan's administration of Medicare. Michigan's response is included in its entirety as Appendix A. Appendix B contains the **HCFA, Office** of Actuary's comments on Michigan's response.

## INTRODUCTION

### BACKGROUND

Michigan administered Medicare Parts A and B operations under cost reimbursement contracts until the contractual relationship was terminated in 1994. Contractors were to follow cost reimbursement principles contained in the Cost Accounting Standards (**CAS**), the Federal Acquisition Regulations (**FAR**) and their Medicare contracts.

Michigan was the Medicare Part A contractor until the contract was terminated effective October 1, 1994 and the Medicare Part B contractor until the contract was terminated effective November 1, 1994. At the request of the HCFA, we audited Michigan's

August 29, 1995 claim of \$8,979,998 for Post Retirement costs to be incurred subsequent to the termination of the Medicare contracts.

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

According to FAR 31.205-6(0)(2), Post Retirement costs can be calculated using one of the following:

**Cash Basis** (or pay-as-you-go) - recognizes costs as Post Retirement when they are actually provided.

**Terminal Funding - accrues and** pays the entire Post Retirement liability to the insurer or trustee in a lump sum upon the termination of employees to establish and maintain a fund or reserve for the purpose of providing Post Retirement to retirees. The lump sum payment is allowable if amortized over a period of 15 years.

**Accrual Basis** - measures and assigns costs according to generally accepted accounting principles and pays an insurer or trustee to establish and maintain a fund or reserve for the sole purpose of providing Post Retirement to retirees. The accrual must be calculated in accordance with generally accepted actuarial principles and practices as promulgated by the Actuarial Standards Board.

The FAR further states that to be allowable, costs must be **funded** by the time set for filing the Federal income tax return or any extension thereof. Post Retirement costs assigned to the current year, but not **funded** by the tax return time, are not allowable in any subsequent year.

In 1990, the Financial Accounting Standards Board issued the Statement of Financial Accounting Standard (SFAS) 106 which established accounting standards for Post Retirement. The SFAS 106 significantly changed the practice of accounting for Post Retirement from the cash basis to the accrual basis.

With the implementation of SFAS 106, companies are required to report in their **financial** statements the accrued liability for Post Retirement for current and retired employees. The SFAS 106 requires the **annual** reporting of net periodic service costs, as well as a transition obligation (i.e., a cumulative effect of an accounting change) which may be recognized either immediately or amortized on a straight line basis over the average remaining service of active plan participants.

The FAR allows contractors the option of electing SFAS 106 accrual accounting for funded Post Retirement, or of continuing to recognize Post Retirement costs on the cash basis for government contract purposes if that had been their practice. However, the FAR does not allow contractors to immediately recognize any SFAS 106 transition obligation. The FAR provides for recognition on an amortized basis.

Medicare contractors were alerted to the SFAS 106 requirements and the FAR options by instructions in the Budget and Performance Requirements for Fiscal Year 1993. Michigan chose to continue using the cash basis for its government contracting purposes and thus recognize Post Retirement costs when they were actually provided.

## SCOPE

We performed our audit in accordance with generally accepted government auditing standards. The objective of our audit was to determine whether Post Retirement costs claimed for the period subsequent to Michigan's termination were allowable for Medicare reimbursement. Achieving our objective did not require that we review Michigan's internal control structure.

We examined Michigan's claim in relation to applicable laws and regulations to determine whether Michigan complied with regulatory requirements.

We conducted our review at the auditee's office in Detroit, Michigan during September 1995. We performed subsequent audit work in our OIG, OAS Jefferson City, Missouri field office.

## FINDINGS AND RECOMMENDATION

Michigan has claimed \$8,979,998 in Post Retirement costs that are unallowable for Medicare reimbursement. The \$8,979,998 represents costs for Post Retirement benefits that Michigan estimates will be incurred after the termination of its Medicare contracts. The claim represented: (1) a retroactive change in accounting basis with immediate recognition of the transition obligation, and (2) a request for reimbursement of unfunded costs. None of these costs are allowable in accordance with the FAR and therefore the costs are **unallowable** for Medicare reimbursement.

Michigan's contractual relationships under Medicare were terminated in 1994. On August 29, 1995 Michigan claimed \$8,979,998 to cover Post Retirement costs subsequent to the contract completion dates. The FAR allows contractors the option of electing SFAS 106 accrual accounting, but it requires the amortization of the transition obligation amount. Additionally, the **FAR** states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof.

Michigan's normal practice for government contracting purposes has been to claim Post Retirement costs on the cash basis. On this basis, Michigan had been reimbursed for actual Post Retirement costs incurred through the contract termination dates. Michigan's subsequent claim for Post Retirement costs was calculated using an accrual basis considering the immediate recognition of the entire transition obligation amount.

The Post Retirement claim is based on the retroactive changing from a cash basis to an accrual basis for claiming Post Retirement costs subsequent to its contract terminations. In addition to being a retroactive change, Michigan's application of the SFAS 106 accrual method of accounting for Post Retirement is not in compliance with the FAR with regard to treatment of a transition obligation. Furthermore, although Michigan's claim is based on the accrual method, Michigan has not established a fund or reserve to provide Post Retirement to retirees. Therefore, Michigan is claiming reimbursement for unfunded costs.

Accordingly, we concluded that Post Retirement costs of \$8,979,998 claimed by Michigan are **unallowable** for Medicare reimbursement and we are recommending that Michigan withdraw the claim.

#### **Recommendation:**

We recommend that Michigan withdraw the August 29, 1995 claim of \$8,979,998 for Post Retirement costs.

#### **Auditee Response**

Michigan's response primarily consisted of the same assertions and opinions that were included in its August 19, 1995 claim. Michigan's assertions and opinions are summarized in the following paragraphs and presented in detail on Appendix A.

Michigan believes that reimbursement of the accumulated Medicare Post Retirement obligation is required under the terms of its Medicare contracts. According to Michigan, **HCFA's** failure to fund Post Retirement costs breaches the Medicare contracts' fundamental principle that Michigan shall experience neither profit nor loss as a result of its Medicare service. Michigan compared its claim for Post Retirement costs to pension costs attributable to Medicare service, which HCFA funded.

Michigan asserts that **HCFA's** termination of the Medicare contracts does not eliminate HCFA'S responsibility to reimburse the accumulated Post Retirement obligation, as it is funded in the future. Michigan points out that if it had been permitted to continue performing the contracts, the Post Retirement costs in question would have been reimbursed by **HCFA**. According to Michigan, HCFA can't **shift** responsibility for the Post Retirement obligation because it elected to terminate Michigan's Medicare contracts. In support of their

position, Michigan cited two court cases which Michigan believes establishes HCFA's liability for accumulated Post Retirement obligation costs that will be incurred by Michigan in the future.

Michigan believes that the CAS supports their position regarding the Post Retirement costs claimed. According to Michigan, Post Retirement costs may be treated under either CAS 412 or 416 with similar results. Michigan also believes that the FAR and SFAS 106 allows for a segment closing adjustment of Post Retirement costs.

Additionally, Michigan asserts that under SFAS 106 the amortization of the transition obligation is required to be accelerated when benefit payments (which are defined to include payments/associated with a settlement) exceed the accrual costs. According to Michigan the Government's undertaking of an action to fund fully a lump sum settlement or to otherwise discharge the Medicare Post Retirement obligation would amount to a settlement within the meaning of SFAS 106. This would in turn require immediate recognition of the remaining unamortized portion of the Medicare Post Retirement transition obligation under paragraph 112 of SFAS 106.

Also, Michigan believes that because we did not challenge or otherwise question their calculations of the Post Retirement costs claimed, that we therefore agree that \$8,979,998 of Michigan's Post Retirement costs are attributable to Medicare.

### **OIG Comments**

We disagree with Michigan regarding the allowability of its Post Retirement costs. We also disagree with the validity and accuracy of Michigan's calculation of the Post Retirement costs. Our reasons for disagreeing are summarized in the following paragraphs. The HCFA, Office of Actuary's detailed comments on Michigan's response are presented on Appendix B.

Michigan's Medicare contracts require that the costs allowable and allocable for administration of the contract be determined in accordance with provisions of Part 31 of the FAR. The FAR 31.205-6(0)(2) sets forth the allowability requirements and applicable methods of accounting for Post Retirement costs. The FAR states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof. Post Retirement costs assigned to the current year, but not funded by the tax return time, are not allowable in any subsequent year.

In regards to Michigan's comparison of Post Retirement costs to pension costs, HCFA reimbursed Michigan for pension costs which Michigan funded during the period of the contracts. Likewise, HCFA reimbursed Michigan for Post Retirement costs that were funded by Michigan during the period of the contracts. The Post Retirement costs that Michigan claimed subsequent to the contracts' **termination** have not been funded.

There are no contractual or regulatory provisions to support Michigan's assertions that HCFA is responsible to reimburse Michigan for the accumulated Post Retirement obligation. Furthermore, the two court cases cited by Michigan pertain to different situations and circumstances and are not relevant.

We agree that CAS 412 and 416 could result in substantially the same amounts of allocable costs. Both standards provide for differing treatments depending on whether the costs are accrued and **funded** or pay-as-you-go.

While Michigan states that the FAR and SFAS support a segment closing adjustment for Post Retirement cost, they cited no provisions in support of their position. There are none. The provisions of FAR 31.205-6(0)(4) are applicable to Michigan's contract, and do not allow for the immediate recognition of the transition obligation. Additionally, there has been no settlement as defined by SFAS 106 paragraph 90. Therefore, SFAS 106 paragraph 112 is not pertinent to Michigan's claim.

We did not challenge or otherwise question Michigan's calculations of the Post Retirement costs claimed because the costs were **unallowable in** their entirety. We did review the pertinent data that provided the basis for Michigan's Post Retirement claim and found that:

While Michigan historically charged Medicare for Post Retirement costs based on an allocation of total company pay-as-you-go costs, the claim in question was separately computed by Michigan's actuary based on 132 individual participants that Michigan identified as Medicare "retirees".

Michigan's claim was based on 100 percent of the 132 Medicare retirees' accumulated Post Retirement obligation. However, historically, Michigan's Medicare segment was only devoted to Medicare operations about 87 percent of the time. **Additionally**, Medicare only accounted for about 12 percent of Michigan's total business.

Michigan's claim assumed that all 132 Medicare retirees worked their entire careers on Medicare operations. Accordingly, Michigan did not attribute any of the retirees' accumulated Post Retirement obligation to non-Medicare operations. Our analysis showed that, on average, the 132 retirees were only devoted to Medicare operations for about 71 percent of their careers.

Of the 132 participants valued by Michigan's actuary as Medicare retirees, we found that 16 were still actively employed by Michigan in non-Medicare operations. We also identified 5 participants that were never included in the Medicare segment and had never worked on Medicare operations. Additionally, we identified one participant that was deceased prior to Michigan's submission of its claim for Post Retirement costs.

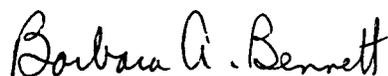
For the above noted reasons, we would not accept the validity and accuracy of Michigan's calculations of the Medicare Post Retirement costs even if the costs were allowable, which they are not.

### INSTRUCTIONS FOR AUDITEE RESPONSE

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

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

Sincerely,



Barbara A. Bennett  
Regional Inspector General for  
Audit Services

Mr. Chester Stroyny  
**Regional** Administrator  
Region V  
105 West Adams Street, 17th Floor  
Chicago, Illinois 60603

Enclosure



Mark R. Bartlett, CPA, CPCU  
Vice President and Controller

600 Lafayette East  
Detroit, Michigan 48226-2998

May 7, 1996

Barbara A. **Bennett**  
Regional Inspector General for  
**Audit Services**  
Office of Inspector General  
Office of **Audit Services**  
601 **East 12th Street**  
Room 284A  
Kansas **City, Missouri** 64106

Re: **CIN: A-07-96-01177**

Dear Ms. Bennett:

Blue Cross Blue **Shield** of **Michigan (BCBSM)** respectfully **submits this** response to your request for comments on the HHS Office of Inspector General for **Audit Services (OIG)** draft **audit report** no. A-07-96-01177, entitled **Post Retirement Benefit Costs Claimed by Blue Cross and Blue Shield of Michigan (Draft Audit Report)**. **BCBSM's** response is being submitted for the purpose of **facilitating** the settlement of **cost issues relating to** our Medicare contracts and **is not to** be construed as an admission of **liability** upon any particular **claim** or figure. **BCBSM's** attached comments are based upon a preliminary **review** of the **Draft Audit Report**; BCBSM reserves the **right to submit** additional information and to contest any **findings**, recommendations or **claims** set forth in or **relating to** the **Draft Audit Report**.

Please **contact** me at 313-225-6922 if you have any questions or **if** we otherwise may be of assistance.

Sincerely,

A handwritten signature in black ink that reads "Mark R. Bartlett". The signature is written in a cursive style with a large, stylized 'M' and 'B'.

Mark R. Bartlett

**BCBSM COMMENTS ON DRAFT PRB COST AUDIT REPORT**

OIG's Draft Audit Report did not raise any quantum issue regarding the \$8,979,998 of Post Retirement Benefit (PRB) costs claimed by BCBSM. Therefore, it is BCBSM's understanding that OIG did not challenge or otherwise question BCBSM's calculations establishing that \$8,979,998 of BCBSM's PRB cost is attributable to Medicare service.<sup>1/</sup> The Draft Audit Report instead consisted mostly of opinions regarding entitlement issues which form the ~~basis for OIG's conclusion that HCFA need not fund the retiree health care benefits offered to workers who served Medicare during the past several decades of BCBSM's Medicare contracting.~~ BCBSM maintains that HCFA is responsible for reimbursing PRB costs attributable to BCBSM's administration of Medicare.

1. Government Reimbursement Of The Accumulated Medicare PRB Obligation Is **Required Under BCBSM's Medicare Contracts**

The fundamental basis of the agreements under which HCFA engaged BCBSM's Medicare administrative services was cost reimbursement:

**It is the intent of this contract that the Carrier, in performing its functions under this contract, shall be paid its cost of administration under the principle of neither profit nor loss to the Carrier . . . .**<sup>2/</sup>

Thus, the intent of the parties was that BCBSM would be responsible for administering Medicare functions for HCFA, which in turn would be responsible for reimbursing the cost of such Medicare service. The cost of Medicare administration included, naturally, the cost of compensating workers to perform such Medicare service. Just as HCFA has funded the pension benefit component of BCBSM's Medicare workers' compensation, it should fund the retiree health care obligation attributable to the same Medicare service. HCFA's failure to provide such funding would be in breach of the Medicare contracts fundamental principle

<sup>1/</sup> Depending upon the timing of and funding vehicle used to implement a settlement of the Medicare PRB obligation, the \$8.9 cost figure will likely need to be adjusted.

<sup>2/</sup> See BCBSM's Medicare Part B contract HCFA 88-016-2, Article XVI (A). BCBSM's Medicare Part A contract 88-001-1.25 contains a virtually identical provision at Article XIII(A).

that BCBSM shall experience neither profit nor loss as a result of its Medicare service.

2. **HCFA's Termination Of BCBSM Is Not A Proper Basis For Avoiding Responsibility To Reimburse The-Accumulated PRB Obligation Attributable To BCBSM's Medicare Service**

The fact that HCFA terminated BCBSM's Medicare contracting in 1994 does not extinguish HCFA's responsibility to reimburse the accumulated PRB obligation attributable to BCBSM's long-term operation of Medicare Part A and Part B services. It is well-established that the Government remains liable for costs which benefited and were caused by contract performance, notwithstanding the fact that the cash outlay for such costs naturally may occur after the term of a contract. See, e.g., United States Rubber Co. v. United States, 160 F. Supp. 492, 499-500 (Ct. Cl. 1958) (increase in contractor unemployment insurance tax cost experienced after contract terminated but attributable to contractor's past employment was a reimbursable cost under the contract). PRB costs similarly are reimbursable employment-related costs that, naturally, continue to be paid after contracting segments close and the workers retire. Clearly, if BCBSM had been permitted to continue performing its Medicare contracts, the Medicare PRB obligation in question would have been reimbursed by HCFA, just as has been the case with BCBSM's Medicare pension obligation produced by the same Medicare service. HCFA cannot properly shift responsibility for the Medicare PRB obligation simply because it elected to terminate BCBSM's Medicare contracts.<sup>3/</sup>

<sup>3/</sup> The Draft Audit Report references a FY93 alert to Medicare contractors regarding FAS 106 and FAR options and states, in essence, that BCBSM "chose" not to charge Medicare for the true, fully accrued cost of PRB. This statement is incomplete and inaccurate for several reasons, including the fact that, until the advent of FAS 106, employers throughout U.S. industry had always recognized and administered PRB on a pay-as-you-go basis. Shortly after the FY93 alert, HCFA terminated BCBSM's Medicare contracts. HCFA thus terminated BCBSM before it could have addressed and recovered the FAS 106 PRB cost built up through decades of prior Medicare service.

Further, the Draft Audit Report's observations regarding "retroactive" changes in cost accounting practices indicate that even if BCBSM had "chosen" earlier to attempt to charge HCFA the

There should be no dispute that **BCBSM's** accumulated PRB obligation **exists** because of **BCBSM's** approximately 25 years of service to the Medicare program. This service was undertaken pursuant to contractual agreements providing that **BCBSM** was not to experience a loss as a result of its Medicare service. Other agencies of the U.S. Government, including the Departments of Energy and Defense, have, under similar situations -- termination of a contractor's long-term service under cost-reimbursement contracts -- agreed to reimburse accrued PRB obligations that are attributable to such service.<sup>4/</sup> In sum, HCFA's termination of **BCBSM's** Medicare contracting is not a proper basis for HCFA to avoid responsibility for reimbursement of the accumulated PRB obligation attributable to **BCBSM's** Medicare service.

3. Cost Accounting Standards Also Support **BCBSM's** Request That **HCFA** Fund The Accumulated Medicare **PRB** Obligation

Although PRB costs may be treated under either CAS 412, if they are an integral part of a pension plan, or under CAS 416, as

3/ ( . . .continued)

accrued cost of PRB, such an election likely would have been opposed as a retroactive change. In any event, the relatively recent issuance of FAS 106 and its requirement that **BCBSM** recognize the accrued cost of the PRB obligation attributable to Medicare service, clearly establish that **BCBSM's** accrual of a PRB obligation was not a voluntary retroactive change in accounting practice. Moreover, HCFA's termination of **BCBSM's** Medicare contracts created a changed situation entirely different from the open-ended, long-term contractual relationship that had been renewed consistently since the inception of **Michigan's** Medicare contracting. Accordingly, **BCBSM's** recovery of Medicare PRB costs claimed should not be deemed to be unallowable because it allegedly would change retroactively a cost accounting practice.

4/ See DOE Order 3890.1, Contractor Insurance and Other Health Benefits Programs (1995) (DOE's policy to pay for post-contract retiree costs through a lump-sum settlement, continued pay-as-you-go reimbursement, or transfer of the PRB obligation to the successor contractor) ; Remington Arms Company, Inc., ACAB No. 1238, 4 Extra. Con. Relief Rptr. ¶ 59 (1991) (Army agreement to fund accumulated PRB obligation after termination of long-term cost-reimbursement operating contract) .

insurance costs, the Cost Accounting Standards (CAS) Board (CASB) has made clear that application of either CAS 412 (pensions) or CAS 416 (insurance) to PRB costs "would result in substantially the same amounts of allocable cost."<sup>5/</sup> Moreover, as acknowledged by the Defense Contract Audit Agency, if PRB had simply been incorporated as an integral part of a pension plan (and thus treated under CAS 412 and 413), a Post-contract segment closing adjustment would be due for any unfunded cost of the segment's PRB obligation.<sup>6/</sup>

5/ That the CASB contemplated equivalent treatment for PRB and pension costs is illustrated by the preamble to CAS 416:

One respondent was concerned about the relationship of this standard to two other cost accounting standards, CAS No. 412, composition and measurement of pension cost, and CAS No. 415, accounting for costs of deferred compensation. The respondent was concerned especially about health insurance carried for retired employees of a contractor; he felt that there might be confusion as to whether such insurance should be considered a form of deferred compensation, a part of a pension plan, or part of an insurance program.

- The Board believes that these standards provide ample criteria for determining which standard is applicable to any given cost. In particular, the question of whether a benefit, such as insurance provided to retired persons, is an integral part of a pension plan and thereby governed by CAS No. 412 or is a part of an insurance program and thereby governed by CAS No. 416 is a question of fact in each given instance. Moreover, application of either standard to this element would result in substantially the same amounts of allocable cost.

CAS 416, Preamble A, Comment 10; CCH CAS Guide at 5351 (emphasis added). All CAS citations within this memorandum refer to the CAS in effect as of 1994, i.e., the last year of BCBSM's Medicare contracting.

6/ See Remington Arms, supra, at 3 (discussion of DCAA's position regarding a contractor's request for reimbursement of PRB costs attributable to past service under a long-term cost reimbursement contract to operate a government facility).

This CASB guidance and the DCAA's reported analysis of the CAS establish that a segment closing adjustment for PRB costs is required. Stated generally, a BCBSM Medicare worker whose service years qualified for immediate retirement with pension benefits is eligible to receive continued PRB coverage. In this respect, BCBSM employees' eligibility to receive PRB was based upon the same conditions that supported their claim to pension benefits. Accordingly, the same Medicare service that produced BCBSM's Medicare pension benefit-obligation would also produce a PRB obligation. The pension element of Medicare compensation costs has been funded by HCFA. By providing the requested adjustment to fund fully the PRB element of Medicare compensation costs upon the closing of BCBSM's Medicare segment, HCFA will comply with the intent of the CAS, that PRB should produce substantially the same charge, whether treated as a pension or an insurance cost.<sup>7</sup>

Further, application of CAS 416 PRB principles, standing alone, would yield the same result as a CAS 413 segment closing adjustment. CAS 416.50(a) (1)(v)(c) provides that funding is required to be apportioned over the working lives of active employees in the plan. BCBSM's request for PRB reimbursement covers a Medicare segment no longer performing a Medicare contracting activity and employees whose active BCBSM working lives ended prior to or with HCFA's termination. Therefore, the requirements of CAS 416 may be satisfied by the Medicare segment's recognition of the accumulated Medicare PRB obligation as a cost in the year in which activity ceased. It follows that the provision of a contract closing adjustment to recognize and fund the accumulated Medicare PRB obligation would be fully consistent with CAS 416 provisions concerning the allocation of PRB costs.

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<sup>7</sup>, See CAS 416, Preamble A, Comment 10.

Finally, the PRB cost in question is clearly the product of HCFA's long-term engagement of BCBSM's Medicare services under cost reimbursement contracts and, because of HCFA's termination of BCBSM's Medicare contracting, there are no future periods in which BCBSM may adjust this cost against Medicare contracts. Compliance with the fundamental CAS principle governing allocability -- allocating costs on the basis of their causal or beneficial relationship to benefiting cost objectives -- would require an adjustment to fund fully the accumulated Medicare PRB obligation.

In sum, relevant CAS provisions require a closing adjustment to BCBSM's Medicare contracts to fund the PRB component of the compensation costs attributable to BCBSM's Medicare *service* -- just as HCFA has funded the pension component of Medicare compensation costs. By doing so, HCFA properly will have funded and reimbursed PRB costs that were caused by and that benefitted Medicare operations, satisfying the intended operation of the CAS .

4. Allocating The Accumulated PRB Obligation To Medicare Contracts Is Consistent With The FAR And FAS 106

The FAR and FAS 106 similarly allow for a segment closing adjustment of PRB costs. FAR 31.205-6 (o) (4) (effective July, 1991), acknowledged the allowability of PRB costs attributable to past service, as defined by FAS 106. This FAR PRB cost principle was amended in August, 1991, in an effort to limit the recognition of past service costs (the transition obligation under FAS 106) as if a contractor had adopted the delayed recognition methodology described in paragraphs 112 and 113 of FAS 106. This FAR amendment apparently was intended to avoid an alternate "immediate recognition" method provided for in paragraph 111 of FAS 106 at the time FAS 106 initially is adopted by a contractor. The amended FAR PRB cost principle was not in existence and applicable to BCBSM during nearly all of the decades-long period in which it was engaged in the Medicare contracting which produced the accumulated Medicare PRB obligation. Thus, the amended FAR's purported limit on the FAS 106 bases for charging a PRB transition obligation should not be applied to BCBSM.

In any event, under FAS 106, even if the delayed recognition method of paragraph 112 has been adopted, the amortization of the transition obligation in future accounting periods is required to be accelerated under circumstances such as have occurred under

BCBSM's Medicare contracts. Paragraph 112 of FAS 106 requires that amortization of the transition obligation be accelerated where benefit payments (which are defined to include payments associated with a settlement) exceed the accrual cost. The Government's undertaking of an action to fund fully a lump-sum settlement or to otherwise discharge the Medicare PRB obligation, would amount to a settlement within the meaning of FAS 106, which in turn would require immediate recognition of the remaining unamortized portion of the Medicare PRB transition obligation under paragraph 112 of FAS 106. Thus, an adjustment to fund and discharge the Medicare PRB obligation is consistent with paragraph 112 of FAS 106 and is thus consistent with the FAR PRB cost principle.

#### CONCLUSION

In sum, BCBSM's Medicare contracts, the FAR, FAS 106 and the CAS all support the same conclusion -- that the PRB transition obligation cost attributable to BCBSM's Medicare contracting can and should be recovered under its Medicare cost reimbursement contracts. Accordingly, a closing adjustment should be made to fund the Medicare PRB obligation, thus complying with the fundamental principle of the Medicare contracts that BCBSM shall not experience a loss from its Medicare service.



**PENSION ACTUARIAL STAFF**

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**MEMORANDUM**

August 22, 1996

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

From: Ronald L. Solomon  
Office of the Actuary

Subject: Response to **Draft** Report CIN A-07-96-0 1177 entitled Post Retirement Benefit Costs Claimed by Blue Cross Blue Shield of Michigan

The Pension Actuarial Staff, Office of the Actuary has reviewed the subject draft report and the response from the auditee, Blue Cross Blue Shield of Michigan (BCBSM), to you dated May 7, 1996. We are providing our comments to you to assist you in your analysis of BCBSM'S response.

As the draft audit report shows, BCBSM has incorrectly claimed that Medicare should be responsible for the **\$8,979,998** post-retirement benefit (PRB) claim by selectively mixing financial accounting rules with cost accounting rules, and funding rules with accrual rules. BCBSM'S response to the draft report is in the same vein. The Federal Acquisition Regulation (FAR) provisions governing allowability of PRB costs are very clear, and BCBSM was made aware of them in a timely manner. The FAR gives contractors a choice when accounting for and charging these costs, and BCBSM made its choice. There is no rationale nor justification for allowing BCBSM to recoup additional money because it now wishes it had made a different choice.

For PRB's, as for many other items of cost, the government has contract cost principles in the FAR that, in conjunction with the allocability provisions of the Cost Accounting Standards (CAS) and generally accepted accounting principles (GAAP), provide guidance for the allowability of specific items of **cost for government contract purposes**. SFAS 106 was effective for BCBSM January 1, 1993. It provides that companies recognize the accrual of PRB costs **for financial statement purposes**. Prior to SFAS 106, GAAP allowed for the recognition of PRB costs as claims were paid, i.e., a pay-as-you-go basis. This same pay-as-you-go basis was used for contract cost purposes.

As a result of SFAS 106, companies using the pay-as-you-go method were

required to change their accounting method for PRB's *for financial statement purposes*. **The** change necessitated recognition of a transition obligation along with yearly determinations of the PRB costs accruing in each year. Under SFAS 106 accrual accounting, companies could elect either of two methods for recognizing the transition **obligation**, immediate or amortized. BCBSM elected the immediate recognition method in 1993.

However, *for government contract cost purposes*, **the** FAR allows contractors the option of electing SFAS 106 accrual accounting in conjunction with the **funding** of their PRB accruals, or of continuing to recognize PRB costs on the pay-as-you-go basis. All Medicare contractors, including BCBSM, were explicitly alerted by HCFA to the SFAS 106 requirements and the FAR options by instructions in the Budget and Performance Requirements (BPR) for fiscal year 1993 that they received by June, 1992. Although BCBSM freely chose to continue using the pay-as-you-go **method**, it is now seeking, after the end of the contract **period**, to retroactively change its accounting method to the **accrual** method. BCBSM's allegation that it incurred a loss completely ignores the fact that it did charge PRB costs to the Medicare contracts on the pay-as-you-go basis during the years it was a contractor, and these costs were reimbursed by Medicare. In **addition**, BCBSM is attempting to claim the entire SFAS 106 immediately-recognized transition **obligation**, an option which is not permitted by the FAR. There is no reason for HCFA to approve any such retroactive change in accounting methodology.

As noted above, BCBSM adopted SFAS 106 in 1993, **after** it had received the 1993 BPR, but chose to continue to account for PRB as pay-as-you-go costs **in** its Medicare contracts budget proposals. Nor did BCBSM make any request to HCFA during either 1993 or 1994 for increased PRB costs over the budget request based on changing its accounting method. Just as the government cannot impose a more favorable (to the government) accounting method on a contractor when **GAAP** and the FAR offer a choice, neither can a contractor retroactively change an accounting method because such change would yield a more favorable (to the contractor) result.

BCBSM tries to buttress its argument by citing the U.S. Rubber case, which dealt with the allowability of increased unemployment taxes assessed after a contract termination. BCBSM'S reference conveniently ignores the crucial fact in that case that an agreement had been signed by the government specifically making such costs allowable provided that they were unforeseen at the time of the agreement but were subsequently identified and had to be paid **by** the contractor. There is no similarity at all between that case and the situation at hand.

Likewise, BCBSM asserts that policies of other government agencies, notably Defense (DCAA) and Energy (DOE), are somehow relevant, notwithstanding the fact that none of these policies were **incorporated** into BCBSM's Medicare contracts. BCBSM

Memo -Barbara A. Bennett  
August 22, 1996

only refers to those parts of the policies that could possibly be interpreted as supporting their views, ignoring salient facts. For example, the Remington Arms case **cited**, and the DCAA policy response thereto, dealt specifically with a **Government-owned, Contractor-operated (GOCO)** facility at which the **government** had participated in the **decision-making** as to how PRB costs would be charged to contracts. Similarly, DOE's policy has been developed mainly for **GOCO's**, and in addition DOE only allows PRB costs to be charged on a pay-as-you-go basis. The government has in fact developed several cost principle modifications because of **the** unique nature of **GOCO's**. There is no relevance of these special GOCO provisions to a **non-GOCO** situation such as existed at BCBSM.

BCBSM'S final argument is that the CAS support its position. Indeed, the treatment of **funded** PRB's under provisions of CAS 412 and 413 when the PRB's are an integral part of a pension **plan**, and the treatment of **funding** under CAS 416 are similar and would result in similar allocable contract costs. The segment closing adjustment provision of CAS 413.50(c)(12) is a special pension provision that is inextricably linked to the **funding** of pension plans. Thus, while BCBSM'S citations of the CAS are **correct**, BCBSM conveniently ignores the irrelevance of these **funding** provisions to the **pay-as-you-go funding** basis it chose to utilize. When pay-as-you-go funding is **used**, similar allocable costs also result under either CAS 412 and 413 or 416, and inexorably lead to the recommendation of the draft audit report.

In summary, BCBSM only cites cases and regulations that are either wholly or partially irrelevant to its situation. When it comes to the specifics of its own **claim**, the response speaks only in generalities. This is because there are no contractual nor regulatory provisions applicable to BCBSM that support its position. Thus the recommendation of the draft audit report is still valid. If I can be of any further assistance, please don't hesitate to contact me.