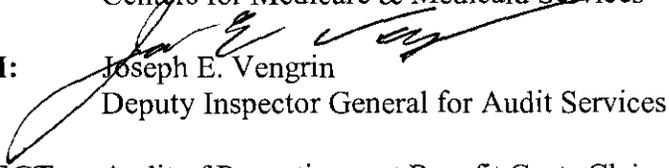




OCT 20 2004

TO: Wynethea Walker
Acting Director, Audit Liaison Staff
Centers for Medicare & Medicaid Services

FROM: 
Joseph E. Vengrin
Deputy Inspector General for Audit Services

SUBJECT: Audit of Postretirement Benefit Costs Claimed for Medicare Reimbursement by Blue Cross and Blue Shield of Texas, Inc. (A-07-03-03040)

Attached is an advance copy of our final report on Blue Cross and Blue Shield of Texas, Inc. (Texas), postretirement benefit (PRB) costs. We will issue this report to Texas within 5 business days. We suggest that you share this report with the Centers for Medicare & Medicaid Services (CMS) components involved with monitoring the Medicare contractors' financial operations, particularly the Office of Financial Management, the Center for Medicare Management, and the Office of the Actuary.

Texas was a Medicare contractor until its contract was terminated in 1999 and, as such, was allowed to claim reimbursement for its Medicare employees' pension costs. Federal regulations set forth the allowability requirements, applicable methods of accounting, and the funding requirements for PRB costs under Government contracts.

Our objective was to determine whether \$6,000,000 for PRB costs claimed in the period subsequent to Texas's termination were allowable for Medicare reimbursement. We determined that Texas's PRB claim represented (1) an unauthorized retroactive change in accounting practice, (2) an immediate recognition of the transition obligation, and (3) a request for reimbursement for deposits made to a revocable trust fund.

According to CMS instructions to contractors, changes in accounting practice require advance approval from the Contracting Officer. Additionally, in accordance with the Medicare contract at Paragraph A of Item II of Appendix B, changes in accounting practice are only permitted on a prospective basis. Furthermore, Federal Acquisition Regulation (FAR) 31.205-6(o)(5) requires the amortization of the transition obligation amount due to a change in accounting methodology. Additionally, funding was not made to an irrevocable trust that satisfies FAR 31.205-6(o)(2)(iii) and Cost Accounting System 416-50(a)(1)(iv) and (v). Since the trust was revocable, it could not be recognized as a plan asset for the sole purpose of providing PRB to retirees as required by Statement of Financial Accounting Standards 106. We recommended that Texas withdraw its claim.

Texas did not accept our finding. Texas stated that it had no other direct method for future reimbursement from the Government for PRB costs since it is no longer a Medicare contractor. Texas's comments are included in their entirety as Appendix A. Texas's comments also address

Page 2 – Wynethea Walker

two other Office of Inspector General reports. Our responses to those comments are included in the respective reports.

Texas did not provide any facts or criteria to change our conclusion that its claim for PRB costs of \$6,000,000 was unallowable for Medicare reimbursement. Therefore, we still recommend that Texas withdraw the December 29, 1999 claim of \$6,000,000 for PRB costs.

If you have any questions or comments about this report, please do not hesitate to call me, or your staff may contact George M. Reeb, Assistant Inspector General for the Centers for Medicare & Medicaid Audits, at (410) 786-7104 or James P. Aasmundstad, Regional Inspector General, Region VII, at (816) 426-3591, extension 225. Please refer to report number A-07-03-03040 in all correspondence.

Attachment



Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

OCT 22 2004

Report Number: A-07-03-03040

Ms. Susan E. Gajda
Vice President, Audit and Performance Services
Health Care Service Corporation
300 East Randolph Street, 11th Floor
Chicago, Illinois 60601-5099

Dear Ms. Gajda:

Enclosed are two copies of the Department of Health and Human Services (HHS), Office of Inspector General (OIG) final report entitled "Audit of Postretirement Benefit Costs Claimed for Medicare Reimbursement by Blue Cross and Blue Shield of Texas, Inc." A copy of this report will be forwarded to the action official noted below for review and any action deemed necessary.

Final determination as to actions taken on all matters reported will be made by the HHS action official. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the 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 reports issued to the Department's grantees and contractors are made available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act that the Department chooses to exercise (see 45 CFR part 5).

Please refer to report number A-07-03-03040 in all correspondence.

Sincerely yours,

James P. Aasmundstad
Regional Inspector General
for Audit Services

Enclosures - as stated

Page 2 – Ms. Susan E. Gajda

Directly Reply to HHS Action Official:

James R. Farris, M.D.
Regional Administrator
Centers for Medicare & Medicaid Services
1301 Young Street, Room 714
Dallas, Texas 75202

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**AUDIT OF POSTRETIREMENT
BENEFIT COSTS CLAIMED FOR
MEDICARE REIMBURSEMENT BY
BLUE CROSS AND BLUE SHIELD OF
TEXAS, INC.**



**OCTOBER 2004
A-07-03-03040**

Office of Inspector General

<http://oig.hhs.gov>

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OAS FINDINGS AND OPINIONS

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed, as well as other conclusions and recommendations in this report, represent the findings and opinions of the HHS/OIG/OAS. Authorized officials of the HHS divisions will make final determination on these matters.



EXECUTIVE SUMMARY

BACKGROUND

Blue Cross and Blue Shield of Texas (Texas) administered Medicare Part A and Part B operations under cost reimbursement contracts with the Centers for Medicare & Medicaid Services (CMS) until the contractual relationship was terminated effective September 30, 1999.

On December 29, 1999, Texas submitted a claim of \$6,000,000 to cover postretirement benefit (PRB) costs to be paid subsequent to the contract completion date. On March 16, 2000, Texas deposited \$5,159,732 into a revocable trust to provide PRBs to retirees. In claiming costs, contractors are to follow cost reimbursement principles contained in the Federal Acquisition Regulations (FAR), Cost Accounting Standards (CAS), and Medicare contracts.

FAR 31.205-6(o) sets forth the allowability requirements and applicable methods of accounting for PRB costs under a Government contract. The PRB costs can include, but are not limited to postretirement 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. PRBs do not include cash benefits and life insurance benefits paid by pension plans during the period following the employees' retirement. 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.

Beginning in 1993, Statement of Financial Accounting Standards (SFAS) 106 required contractors to report their accrued liability for PRBs for current and retired employees in their financial statements. FAR allows contractors the option of electing SFAS 106 accrual accounting for funded PRBs or continuing to recognize PRB costs on the cash or terminal funding basis for Government contract purposes, whichever had been their practice. If accrual accounting is elected, then the initial unfunded liability, which SFAS 106 refers to as the transition obligation, must be amortized in accordance with FAR 31.205-6(o) in order to be allowable.

OBJECTIVE

Our objective was to determine whether PRB costs claimed in the period subsequent to Texas's termination from the Medicare program were allowable for Medicare reimbursement.

SUMMARY OF FINDINGS

Texas's PRB claim, submitted subsequent to the contract termination, was not in compliance with Government regulations. The claim represented (1) an unauthorized retroactive change in accounting practice, (2) an immediate recognition of the transition obligation, and (3) a request for reimbursement for deposits made to a revocable trust fund.

According to CMS instructions to contractors, changes in accounting practice require advance approval from the Contracting Officer. Additionally, in accordance with the Medicare contract

at Paragraph A of Item II of Appendix B, changes in accounting practice are only permitted on a prospective basis. Furthermore, FAR 31.205-6(o)(5) requires the amortization of the transition obligation amount due to a change in accounting methodology. Additionally, funding was not made to an irrevocable trust that satisfies FAR 31.205-6(o)(2)(iii) and CAS 416-50(a)(1)(iv) and (v). Since the trust was revocable, it could not be recognized as a plan asset for the sole purpose of providing PRB to retirees as required by SFAS 106. Therefore, the \$6,000,000 claim was unallowable for Medicare reimbursement.

RECOMMENDATION

Texas should withdraw the December 29, 1999 claim of \$6,000,000 for PRB costs.

AUDITEE'S COMMENTS

Texas did not accept our finding. Texas stated that it had no other direct method for future reimbursement from the Government for PRB costs since it is no longer a Medicare contractor. Texas' comments are included in their entirety as Appendix A. Texas's comments also address two other Office of Inspector General (OIG) reports. Our responses to those comments are included in the respective reports.

OIG RESPONSE

Texas did not provide any facts or criteria to change our conclusion that its claim for PRB costs of \$6,000,000 was unallowable for Medicare reimbursement.

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Glossary of Abbreviations and Acronyms

FAR	Federal Acquisition Regulations
CAS	Cost Accounting Standards
PRB	Postretirement Benefits
OIG	Office of Inspector General
OAS	Office of Audit Services
CMS	Centers for Medicare & Medicaid Services

INTRODUCTION

BACKGROUND

Medicare

Texas administered Medicare Part A and Part B under cost reimbursement contracts since the start of the Medicare program until the contractual relationship was terminated effective September 30, 1999. In claiming costs, contractors were to follow cost reimbursement principles contained in FAR, CAS, and their Medicare contracts.

Regulations

FAR 31.205-6(o) sets forth the allowability requirements and applicable methods of accounting for PRB costs under a government contract. The PRB costs can include, but are not limited to postretirement 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. PRBs do not cover cash benefits and life insurance benefits paid by pension plans during the period following the employees' retirement. 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.

Beginning in 1993, SFAS 106 required contractors to report their accrued liability for PRBs for current and retired employees in their financial statements. FAR allows contractors the option of electing SFAS 106 accrual accounting for funded PRBs or continuing to recognize PRB costs on the cash or terminal funding basis for Government contract purposes, whichever had been their practice. If accrual accounting is elected, then the initial unfunded liability, which SFAS 106 refers to as the transition obligation, must be amortized in accordance with FAR 31.205-6(o) in order to be allowable.

Texas's Actions

Texas's contractual relationship under Medicare was terminated on September 30, 1999. On December 29, 1999, Texas submitted a claim of \$6,000,000 to cover PRBs to be paid subsequent to the contract completion date. On March 16, 2000, Texas deposited \$5,159,732 into a revocable trust to provide PRBs to retirees.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

Our objective was to determine whether PRB costs claimed for the period subsequent to Texas's termination were allowable for Medicare reimbursement.

Scope

At the request of CMS, we reviewed Texas's December 29, 1999 claim of \$6,000,000 for PRB costs to be incurred subsequent to the termination of the Medicare contract.

We did not review Texas's internal control structure because it was not relevant to our objective.

Methodology

We reviewed Texas's 1999 Final Administrative Cost Proposal and supporting schedules, the trust agreement entered into by Texas for purposes of funding the PRB, and plan participant data supporting the PRB calculation, as provided by Texas. We examined Texas's PRB claim in relation to applicable laws and regulations to determine whether Texas complied with regulatory requirements.

We performed the review in conjunction with our audits of Texas's pension segmentation and pension closing of a terminated contractor. We used the information obtained and reviewed during those audits in performing this review.

Our audit was performed in accordance with generally accepted government auditing standards.

FINDINGS AND RECOMMENDATION

The PRB claim submitted by Texas subsequent to the contract termination was not in compliance with Government regulations. The claim represented (1) an unauthorized retroactive change in accounting practice, (2) an immediate recognition of the transition obligation, and (3) a request for reimbursement for deposits made to a revocable trust fund, rather than an irrevocable trust fund. Therefore, the \$6,000,000 claim was unallowable for Medicare reimbursement.

Changes in accounting practice require advance approval from the Contracting Officer and are only permitted on a prospective basis. Furthermore, Federal regulations require the amortization of the transition obligation amount due to a change in accounting methodology. Additionally, Federal regulations specify that deposits must be made to an irrevocable trust in order to be eligible for Medicare reimbursement.

CRITERIA

According to FAR 31.205-6(o)(2) PRB, costs can be calculated using one of the following bases:

Cash Basis (or pay-as-you-go) recognizes PRB costs when they are paid.

Terminal Funding recognizes the entire PRB liability as a lump-sum payment upon termination of employees. The lump-sum payment must be remitted to an insurer or trustee for the purpose of providing PRBs 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 costs to an insurer or trustee to establish and maintain a fund or reserve for the sole purpose of providing PRBs to retirees. The accrual must be calculated in accordance with generally accepted actuarial principles and practices as promulgated by the Actuarial Standards Board.

In 1990, the Financial Accounting Standards Board issued SFAS 106, which established accounting standards for PRBs. SFAS 106 significantly changed the practice of accounting for PRBs 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 PRB for current and retired employees. 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.

FAR allows contractors the option of electing SFAS 106 accrual accounting. 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. PRB costs assigned to the current year, but not funded by the tax return time, are not allowable in any subsequent year. Additionally, FAR requires the amortization of the transition obligation amount due to a change in accounting methodology.

FAR 31.205-6(o)(5) states:

Costs of post retirement benefits in subdivision (o)(2)(iii) of this subsection attributable to past service (“transition obligation”) as defined in Financial Accounting Standards Board Statement 106, paragraph 110, are allowable subject to the following limitation: The allowable amount of such costs assignable to a contractor fiscal year cannot exceed the amount of such costs which would be assigned to that contractor fiscal year under the delayed recognition methodology described in paragraphs 112 and 113 of Statement 106.

SFAS 106 paragraph 112 states: “If delayed recognition is elected, the transition obligation or asset shall be amortized on a straight-line basis over the average remaining service period of active plan participants”

Since FAR 31.205-6 (o) relies on SFAS 106 for the accounting measurement, the trust must also be recognized as a plan asset. According to SFAS 106 paragraph 64: “Assets not segregated in a trust, or otherwise effectively restricted, so that they cannot be used by the employer for other purposes are not plan assets for purposes of this Statement, even though the employer may intend that those assets be used to provide postretirement benefits.”

Medicare contractors were annually alerted to the SFAS 106 requirements and the FAR options by instructions in the Budget and Performance Requirements beginning with fiscal year 1993. Additionally, CMS specifically reminded Texas of these requirements in a letter dated June 6, 1997 to Ms. Marti Mahaffey. Texas chose to continue using the cash basis for its Government contracting purposes and thus recognize PRB costs when they were actually provided.

RETROACTIVE CHANGE IN ACCOUNTING PRACTICE

The PRB claim was based on an unauthorized retroactive change from a cash basis to an accrual basis for claiming PRB costs subsequent to Texas's contract termination.

Since 1993, the annual Budget Proposal Request instructions sent to Medicare contractors have included a reminder of the special provisions regarding costs of PRB plans. The instructions specified that any change in accounting practice for PRB costs must be submitted to CMS in advance for approval. Additionally, CMS specifically reminded Texas of these requirements in a letter dated June 6, 1997 to the Vice President of Medicare Operations, which stated: “. . . an election to change from cash accounting to accrual accounting is considered an accounting practice change which requires advance approval from the Contracting Officer (Director of BPO).”

Texas requested, but never received, CMS's approval for the change in accounting practice. Therefore, Texas's change in accounting practice was unauthorized.

In addition to being unauthorized, Texas's retroactive change in accounting practice was also unallowable. Paragraph A of Item II of Appendix B to the Medicare contract requires that the contractor use the same accounting practice to estimate, accumulate, and report costs. Therefore, in accordance with the Medicare contract, changes in accounting practice are only permitted on a prospective basis and retroactive changes are not allowed.

Additionally, retroactive changes in accounting practice are not in conformity with generally accepted accounting principles. In a decision issued by the Armed Services Board of Contract Appeals,¹ the judge ruled:

Appellant, in effect, wishes to change retroactively the method of accounting for Although the revised method if it had been adopted initially might well have been acceptable and proper, no justification exists for selecting this particular item of cost on an ex post facto basis for special treatment. To do so would be inconsistent . . . and not in conformity with generally accepted accounting principles. Neither appellant nor the Government (in the absence of some possible peculiar circumstance not present here) may retrospectively change the accounting treatment of an item of cost to the prejudice of the other. The commercial havoc which could otherwise ensue is obvious. [Emphasis added.]

IMMEDIATE RECOGNITION OF TRANSITION OBLIGATION

Texas's application of the SFAS 106 accrual method of accounting for PRBs was not in compliance with FAR with regard to treatment of a transition obligation. Texas's claim was based upon the immediate recognition of the transition obligation.

¹Appeal of Blue Cross and Blue Shield Association, 86-2 BCA P 18,751, ASBCA No. 26,529.

FAR allows contractors the option of electing SFAS 106 accrual accounting, but it requires the amortization of the transition obligation amount. If accrual accounting is used, then the transition obligation must be amortized in accordance with FAR 31.205-6(o)(5). FAR sets forth no circumstances in which immediate recognition of costs is allowable.

FUNDING NOT MADE TO IRREVOCABLE TRUST

Texas's accrual funding was not made to an irrevocable trust that satisfies FAR 31.205-6(o)(2)(iii) and CAS 416-50(a)(1)(iv) and (v). Since the trust was revocable, it could not be recognized as a plan asset for the sole purpose of providing PRB to retirees as required by SFAS 106.

EFFECT

Texas claimed \$6,000,000 in unallowable PRB costs.

RECOMMENDATION

Texas should withdraw its December 29, 1999 claim of \$6,000,000 for PRB costs.

AUDITEE'S COMMENTS

Texas did not accept our finding. Texas stated that it had no other direct method for future reimbursement from the Government for PRB costs since it is no longer a Medicare contractor. Texas's comments are included in their entirety as Appendix A. Texas's comments also address two other OIG reports. Our responses to those comments are included in the respective reports.

OIG RESPONSE

Texas did not provide any facts or criteria to change our conclusion that its claim for PRB costs of \$6,000,000 was unallowable for Medicare reimbursement.

OTHER MATTERS

Texas was not able to provide supporting documentation for the calculation of the PRB costs, but did provide a listing of 1,144 plan participants that were used to measure the claimed amount. We determined that 1,041 of the plan participants were in the Medicare segment.

APPENDIX



**BlueCross BlueShield
of Texas**

March 30, 2004

James P. Aasmundstad
Regional Inspector General for Audit Services, Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

Subject: USDHHS, OIG, OAS Draft Audit Reports related to Blue Cross and Blue Shield Of Texas (former) Medicare Contract (terminated September 30, 1999)--
--Report#A-07-03-03032 titled Blue Cross and Blue Shield of Texas Pension Segment Closing Audit (dated July 2003)(audit#1 of the series below)
--Report#A-07-03-03046 titled Review of Pension Costs Claimed for Medicare Reimbursement by Blue Cross and Blue Shield of Texas, Inc. (dated September 2003)(audit#2 of the series below)
--Report#A-07-03-03040 titled Audit of Post Retirement Benefit Costs Claimed Claimed for Medicare Reimbursement by Blue Cross and Blue Shield of Texas Inc. (dated February 2004)(audit#3 of the series below)

Dear Mr. Aasmundstad:

The subject draft reports, referred to below as audits #1, #2, and #3 in a series respectively, are the result of OIG on-site reviews performed during October 2002 and February 2003 as well as prior and subsequent exchanges of information between OIG (including Office of the Actuary), Blue Cross and Blue Shield of Texas (a Division of Health Care Service Corporation, a Mutual Legal Reserve Company), HCSC's engaged outside Actuarial Consultant (Watson Wyatt), and to some extent Blue Cross and Blue Shield of South Carolina staff (including their outside Actuarial firm Chicago Consulting Actuaries) materially through July and October of 2003. We have remained in periodic contact with the audit team during the intervals of audits, follow-up, and draft series issuance. Our pre-arranged approach and intention was to review and respond to the three audit drafts in the series collectively at the same time based on receipt of the last. We appreciate the OIG/HHS/CMS efforts, cooperation, and professional approach in these matters.

The background information contained in the "Background-Texas" sections of each report (each attached for reference) seems to adequately characterize the history and circumstances leading to these final audits under the Medicare Program, therefore we have not restated that here. Each audit/audit report is very specific to an area of contract cost reimbursement and highly technical in nature. Each audit report incorporates reference to Medicare Program/CMS/HCFA/HHS rules, CAS, FAR, FPR, the actual Medicare Contracts, contractor practices, previous audits, and certain events or transactions which we have reviewed but which we have not attempted to re-



**BlueCross BlueShield
of Texas**

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HCSC/OIG draft audit reply

audit or refute in detail and which we do not attempt to restate or pick-apart in our response.

We view and have approached this series of three audit drafts as related and to an extent interdependent. The three draft reports and the handling of the recommendations collectively address three remaining primary open issues related to or resulting from the termination of the Texas Medicare Contract(s) effective September 30, 1999.

Audit #1 draft identifies "excess" pension plan assets at a point in time associated with Medicare Segmentation and CAS methodologies which the OIG recommends HCSC remit (from corporate assets since that can not/should not occur from the remaining ongoing qualified Pension plan after all former Medicare employees were paid accrued lump sum benefits in full) to the Federal Government (based on the concept that the Government Program had over time actually reimbursed previous pension contribution cost claims pursuant to that "excess" funding).

Audit #2 draft is related to the historical annual allowable administrative cost (pension contributions allocated) claims (FACP based) of BCBSTX and based on the auditors' review of previous governmental cost filings, books, records, methods, audit reports and actuarial data (or retrospectively re-applied auditor methodology against that same information) leads the OIG to recommend that HCSC remit \$3,023,483 identified as "unallowable costs" to the Federal Government.

Audit #3 is related to the extraordinary circumstance at contract end when during the directed transition of the Texas Medicare Contract from BCBSTX (TrailBlazer Health Enterprises, LLC a wholly owned subsidiary which held the contract at the time) to Blue Cross and Blue Shield of South Carolina as a condition of transition/sale BCBSTX/HCSC agreed to fund a trust with the actuarially determined accumulated "past service cost" necessary to provide a (future post-retirement) health care benefit upon retirement for transitioned (retained in employment of new contractor) employees and leads the OIG to recommend that BCBSTX (HCSC) withdraw its original previously un-reimbursed estimated cost claim of \$6,000,000 (\$5,159,732 actual deposited after close).

While associating the results of all three audits in the series is important to conclusion, audit#1 and portions of #2 must be tied together and are interlocked in arriving at logical consistent finding. HCSC in conjunction with Watson Wyatt actually calculated and furnished the resulting amount quoted in audit #1 directly from its own maintained valuations and records based on strict collaborative application of techniques required and employed in CAS pension accounting and segmentation rules. The resultant amount is effectively partially based and effectively also partially derived based on the cost computations, allocations, charges, submissions, and reimbursement (and visa versa) along the way. Therefore, if it represents is a good acceptable result, which parties



**BlueCross BlueShield
of Texas**

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HCSC/OIG draft audit reply

already agree it equitably does, then the related basis or pathway leading to it (partially subject of audit#2) is virtually substantiated and if that were to be altered the result could be altered.

Audit #2 has two distinct separate areas it explores for finding. One aspect is purely related to findings/recommendations from a past (last period ending before this audit period begins) pension segmentation audit where parties mutually agreed on valuation and charge techniques under CAS to be employed going forward and which resulted in certain booked adjustments to program costs. As a result of the booked adjustments to program costs a piece (pension plan years and program fiscal years crossed) of the cost adjustment credit the program would receive fell in a prior already filed year. The piece of credit that fell into that previously just filed year was embedded within overall amounts "reduced", not claimed and not reimbursed from that previous year. The adjustment was properly calculated which resulted in a portion being credited into the open year but the properly apportioned amount of the credit amount falling back into the prior program year was not "refunded/refundable/re-reportable" because it was effectively not charged or reimbursed within the actual final FACP. This method of cost reduction-to-unallowable cost offset is acceptable and was actually documented in 1995 HCFA memoranda. We have previously replied to the auditors on this aspect of audit#2 as excerpted again in reply here, as follows:

".....Related to the below your additional question... While researching the records we found that we had apparently received a "Risk Assessment" summary letter with some questions related to the 91-94 reviews (received and replied in 99) which had included among other things a verification of the handling of your same 94 pension audit amount/question. That response (drafted June 99 for HCFA RO Dallas---paraphrased---"HCFA recommends that the FACP's be reduced by \$874,111 to reflect an adjustment identified in the pension segment audit.... The required adjustment has already been made to the FY 1994 FACP....It was included with various other adjustments on the workpapers which were audited and not separately identified....There should be no further adjustment for this finding....") was found to be consistent with our initial response to the 94 audit, with follow up correspondence, with the 94 filing workpapers we reviewed, and was accepted by and closed with HCFA. The amount "credited" based on method alignment agreed upon during the audit related to CAS limits for that isolated period versus contributions for that isolated period were properly allocated to the Medicare lines. The actual credit was tabulated based on our consistent allocation method but still represented the underlying theory represented by the 94 audit finding amount (audit finding amount was estimated to be \$874,111), and our reply. Our Medicare lines' credit (Total and Medicare lines impact documented in our materials furnished during your current audit) was actually for a total of \$1,046,280. The available "Voluntary Cost Reductions" at 9-30-94 were \$5,432,232. In essence the FY 94 Medicare charges for pension cost were reduced by \$1,046,280. from the original filed FACP reported amounts. We do find the action and amounts as described here to be properly supported in the original FACP workpaper file, in subsequent correspondence, and in the risk assessment reply....."

P.O. Box 655730 • Dallas, Texas 75265-5730 • www.bcbstx.com

*Blue Cross and Blue Shield of Texas, a Division of Health Care Service Corporation, a Mutual Legal Reserve Company'
HMO plans offered by Southwest Texas HMO, Inc.* d/b/a HMO Blue' Texas
Independent Licensees of the Blue Cross and Blue Shield Association



Page 4 March 30, 2004 letter
HCSC/OIG draft audit reply

The second aspect of audit #2 is much more complicated and required significant review on our part to understand the wording of the finding and the actual auditor calculations/workpapers underlying the auditor's approach and apparent finding. We previously replied in-part to the auditors on this bullet of the early draft as follows:

".....We have invested time carefully reviewing your draft#2, including with Watson Wyatt CAS staff and attempting to reconcile the different numbers and approaches. We have needed to locate/dig back through older FACP files/workpapers to address certain points. Proper consideration of draft/aspect #2 requires a certain amount of correlation with draft/aspect #1, and to an extent with past filings and with past audits.....we have been off and on somewhat perplexed while we examined this draft#2 and have needed to set it aside/pick it back up/reflect over several possible questions/alternatives. We have been careful to take extra time and have considered discussing some of our initial concerns....it is possible that the best/most efficient way to handle this complicated topic is by written reply protocol....."

After that and further detail consideration we do not and can not agree (supported firmly by the re-review of our involved, experienced outside Actuary) with the statement made in and throughout the second finding (basically--"Texas not basing its pension claims ...on separately calculated pension costs for the Medicare segment..."). We have in fact consistently based our pension valuations, allocations, computations, and charges on very well engineered, acceptable, agreed, consistent methods aligned with the intent of CAS, in accordance with CAS and equitable to the program involved. These employed methods in our opinion have been previously reviewed/effectively agreed by the OIG during and following prior pension related audits (and which is supported evidenced in prior audits related to years not questioned). After considerable reexamination of all of the historical data used in our original results and furnished during the audit as well as what was furnished back by the auditor we find that: the findings and calculations demonstrated in audit#2 finding#2 may in fact first simply miss entirely the actual methodology that was employed by us (allocations to segment and to cost centers within CAS limits actually directly based on individual actuarial assigned pension CAS cost) and how that ties perfectly well into the results of audit #1; the auditor methods are seemingly re-applied employing top-sided global desk techniques that we do not fully comprehend nor agree apply consistently in context with our overall factors and outcomes which are based on solid approaches; the auditor approach results IF presumed on the surface to be otherwise validly approached are flawed within themselves because they do not incorporate accurate starting amounts for years 94 and 99 (the auditor apportions pension plan years contribution activity to equate to FY years using arbitrary ½ year conventions ignoring that the numbers on the lead-in year are already set at 56.2% and numbers on the ending truncated/valued short year would be at 100% or at a minimum 99.6% if you discount a trailing contribution adjustment deposit made a month late)(which IF plugged into the auditor formula would result in a surface comparative difference result of \$765,539 not \$2,149,372 IF method were otherwise accepted).



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However, while having to continue to locate and go back through all of the detail and audit trail involved in re-consideration of the problems presented in audit#2 (which ripples back to audit #1) we have discovered at least two things. One we will herein adjust immediately (revised copy to be furnished electronically for the auditors'/actuary's files). The second may need at least to be carefully considered in context by parties. First--The summary spreadsheet furnished as supporting audit #1 results titled "Remaining Medicare Assets" failed to copy down a set of attributable allocation percentages only in the "other" column in the early years of 91, 92, 93 immediately following years of 0% and where contribution had re-commenced. This correction results in an additional small attribution of "other" contributions which slightly raises the ending Medicare ending weight ratio applied to ending assets which results in an addition of \$398,518 in "Medicare portion of remaining assets" identified or an ending identified remaining asset number of \$11,152,093 related to audit#1 vs \$10,753,575 reported. Nothing else about the underlying methods or ultimate results changed. Second—We did not attempt to factor for this circumstance in our calculations but upon discovery of the earlier FACP work papers while researching audit #2 finding#1 and #2 it is interesting to note that we were not able to claim the actual properly based equitable pension contribution allocation during past FY 93 (which is crossed by the settlement nature of the audit #1) due to budgetary cost cut-backs and more voluntary cost reductions. Those filing work papers reflect a reduction of \$1,258,436 in pension costs not filed/not claimed. This very well could be a factor when considering refunding of identified excess assets it would seem.

Audit #3 presents a dilemma related to laws, regulations, timing, facts and circumstances, what is logical, what is fair, what makes the most sense in context, and intents. BCBSTX exited the Medicare contractor business by agreement after having successfully with much favorable recognition participated in the program since its inception. BCBSTX and the long term employees of its Medicare division had been dedicated and had contributed to the development of the overall program and its operation. The government we think appreciated the efforts described and the government was aware of and participated to an extent in the negotiating of the "transition" of the Texas contract to a comparable contractor. The interest of the transitioning long term employees and the stability of operation of the contract for the Medicare beneficiaries was a paramount concern. Texas management (and SC management) approached the transition carefully within the constraints of operating the program as it advanced. Both parties to the transaction worked ethically to handle the payment and continuation of a form of pension benefits for impacted employees. Both parties sought a way under the rules and past practices to ensure the impacted employees would be able to retain a reasonable form of retiree health benefit.



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The method that surfaced that would ensure retiree health benefit (accruals) for active impacted employees (retired employees by the way were on a pay-as-you-go basis and that future cost was not sought from the government but Texas has continued to pay that cost) was to create/fund a trust fund out-of-corporate-pocket(Texas) in support of past-service cost already actuarially accrued (but not yet claimed or reimbursed under a pay-as-you-go approach) for that benefit for those employees on top of which the new employer would then only need to fund future service cost accruals. Otherwise under the given ongoing possible budgetary constraints of the new employer the benefit might not have been continued based on lengthy prior service. \$5,159,732 was funded by BCBSTXMCSC and handed over to a trust to be operated by the new contractor BCBSSC. The agreement and the trust (which is being modified we now understand by BCBSSC to qualify with OIG instructions/findings) was designed to be tightly monitored and controlled so that the funds and growth could only be used for the specific impacted employees as they worked to fruition. The transition/sale agreement also required the new employer which was already a Medicare contractor to attempt to value and budget the funded past service costs in their normal post-retirement medical valuation process creating legitimate future amortized program cost claims IF the government was not going to reimburse the initial funding as part of the contract termination final filings by Texas. BCBSSC has not filed any related cost amortizations and may not have the budget room to do so, and may be facing future program budgetary changes that may preclude them from being able to do that. BCBSTXMCSC one might say continued to "do the right thing" when it funded these costs in an effort to support the transition of the employees and the stability of the program. BCBSTX would have in the long run if it had stayed in the contract presumably continued these benefits and charged the program on a cash basis over time for these same related costs. BCBSTXMCSC has made reasonable attempts to recover these costs under avenues that applied to it as a Medicare program contractor. BCBSTX has no other direct method for future reimbursement from the government since it is no longer a Medicare contractor, except through the audit review/settlement process. BCBSTXMCSC it seems after discussion with BCBSSC again finally recently (due to this audit result) may not have BCBSSC as a reasonable resource for reimbursement of these costs. HCSC does not find the finding as stated in the audit draft as acceptable. HCSC does have (and did furnish detail actuarial calculation files supporting this funded cost) and can supply any further information needed with dual actuarial firm support. HCSC prefers not to withdraw the basis for the claim of these costs. HCSC appeals to the governmental agencies that issue the audits, review the audits, and consider settlements to reconsider recognition of these reasonable legitimate costs associated with audit draft #3.



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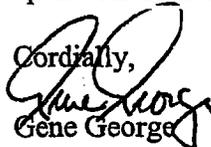
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Based on this collective response we propose the following related to finalization, closure and settlement of these audits and will act promptly upon issuance of final audit reports or agreements reflecting the above, the same, and the below. We will work with the OIG or other agencies on any additional reasonable information needed to consider this.

Audit draft #1 HCSC recognizes in excess pension plan assets at a point--- \$11,152,093.
Audit draft #2 HCSC rests on its allocated and filed pension costs-----\$-0-
Audit draft #3 HCSC splits the funded costs with the government
and will advise BCBSSC not to attempt claims
of these related reimbursed costs in the future -----\$ (2,579,866)
Total from HCSC to Federal Government as full/final settlement-----\$ 8,572,227

Please let us know when you have reviewed and considered these responses. If you have any questions we will assist. When you issue your final reply or your final reports we will promptly reply further.

Thank you and your staff again for your time, patience, professionalism, and consideration. Please send any reply or questions to Gene George (address below)(972-766-6192)(email Gene_George@bcbstx.com) who coordinated the audit activity from an operational/historical standpoint so those may be expedited as necessary internally.

Cordially,

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Attachments OIG audit draft copies