DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Offices of Audit Services

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

August 6, 2004

Report Number: A-07-03-03044

Mr. Kenneth Brause
Vice President Investor Relations
Horizon Blue Cross Blue Shield of New Jersey
3 Penn Plaza East, PP-16T
Newark, New Jersey 07105-2210

Dear Mr. Brause:

Enclosed are two copies of the Department of Health and Human Services (HHS), Office of Inspector General (OIG) report entitled *"Post Retirement Benefit Costs Claimed by Horizon Blue Cross Blue Shield of New Jersey."* 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 named below. 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 the information 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-07-03-03044 in all correspondence.

Sincerely yours,

James P. Aasmundstad
Regional Inspector General
for Audit Services

Enclosures

Direct Reply to HHS Action Official:

Ms. Judith Berek
Regional Administrator, Region II
Centers for Medicare & Medicaid Services
26 Federal Plaza, 38th Floor
New York, New York 10278

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

POST RETIREMENT BENEFIT COSTS CLAIMED BY HORIZON BLUE CROSS BLUE SHIELD OF NEW JERSEY

AUGUST 2004
A-07-03-03044

Office of Inspector General
http://oig.hhs.gov

The mission of the Office of Inspector General (OIG), as mandated by Public Law 95-452, as amended, is to protect the integrity of the Department of Health and Human Services (HHS) programs, as well as the health and welfare of beneficiaries served by those programs. This statutory mission is carried out through a nationwide network of audits, investigations, and inspections conducted by the following operating components:

Office of Audit Services

The OIG's Office of Audit Services (OAS) provides all auditing services for HHS, either by conducting audits with its own audit resources or by overseeing audit work done by others. Audits examine the performance of HHS programs and/or its grantees and contractors in carrying out their respective responsibilities and are intended to provide independent assessments of HHS programs and operations in order to reduce waste, abuse, and mismanagement and to promote economy and efficiency throughout the department.

Office of Evaluation and Inspections

The OIG's Office of Evaluation and Inspections (OEI) conducts short-term management and program evaluations (called inspections) that focus on issues of concern to the department, the Congress, and the public. The findings and recommendations contained in the inspections reports generate rapid, accurate, and up-to-date information on the efficiency, vulnerability, and effectiveness of departmental programs. The OEI also oversees State Medicaid fraud control units, which investigate and prosecute fraud and patient abuse in the Medicaid program.

Office of Investigations

The OIG's Office of Investigations (OI) conducts criminal, civil, and administrative investigations of allegations of wrongdoing in HHS programs or to HHS beneficiaries and of unjust enrichment by providers. The investigative efforts of OI lead to criminal convictions, administrative sanctions, or civil monetary penalties.

Office of Counsel to the Inspector General

The Office of Counsel to the Inspector General (OCIG) provides general legal services to OIG, rendering advice and opinions on HHS programs and operations and providing all legal support in OIG's internal operations. The OCIG imposes program exclusions and civil monetary penalties on health care providers and litigates those actions within the department. The OCIG also represents OIG in the global settlement of cases arising under the Civil False Claims Act, develops and monitors corporate integrity agreements, develops model compliance plans, renders advisory opinions on OIG sanctions to the health care community, and issues fraud alerts and other industry guidance.

Notices

THIS REPORT IS AVAILABLE TO THE PUBLIC
at http://oig.hhs.gov/

In accordance with the principles of the Freedom of Information Act, 5 U.S.C. 552, as amended by Public Law 104-231, Office of Inspector General, Office of Audit Services, reports are made available to members of the public to the extent information contained therein is not subject to exemptions in the Act. (See 45 CFR Part 5.)

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 awarding agency will make final determination on these matters.

EXECUTIVE SUMMARY

Objective

Our objective was to determine the allowability of $2,652,795 in Post Retirement Benefit (PRB) costs claimed for Medicare reimbursement by Horizon Blue Cross Blue Shield of New Jersey (Horizon). The $2,652,795 represents PRB costs that will be incurred subsequent to the termination of Horizon's Medicare contract.

Background

Horizon administered Medicare Part A under a cost reimbursement contract until the contractual relationship was terminated effective July 31, 2000. In claiming costs, contractors are to follow cost reimbursement principles contained in the Federal Acquisition Regulations (FAR), the Cost Accounting Standards (CAS), and their Medicare contracts. The FAR sets forth the allowability requirements and applicable methods of accounting for Post Retirement Benefit (PRB) costs under a Government contract.

Summary of Findings

The review showed that Horizon's claim for $2,652,795 of PRB costs is unallowable for Medicare reimbursement.

Recommendations

We recommend that Horizon withdraw its claim for the $2,652,795 of unallowable PRB costs.

Horizon's Comments

Horizon did not comment on our finding and recommendation.

TABLE OF CONTENTS

INTRODUCTION

BACKGROUND

Horizon administered Medicare Part A under a cost reimbursement contract until the contractual relationship was terminated effective July 31, 2000. In claiming costs, contractors are to follow cost reimbursement principles contained in the FAR, the CAS, and their Medicare contracts.

The FAR 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 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. The PRBs do not cover cash benefits and life insurance benefits paid by pension plans during the period following the employees' retirement.

The FAR 31 allows contractors to choose one of three accounting methods for measuring and assigning PRB costs to accounting periods. 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.

Beginning in 1993, Statement of Financial Accounting Standards (SFAS) 106 required contractors to report the accrued liability for PRBs for current and retired employees in their financial statements. The FAR allows contractors the option of electing SFAS 106 accrual accounting for funded PRBs, or recognizing PRB costs on the cash or terminal funding basis for Government contract purposes, if that had been their practice.

Horizon

When Horizon terminated the Medicare segment of its business, the majority of its Medicare employees terminated employment or transferred to the successor Medicare contractor, Tennessee Blue Cross Blue Shield, doing business as Riverbend Government Business Administrators (Riverbend).

In its July 13, 2001 termination expense voucher for the months April and May 2001, Horizon submitted a claim for PRB costs totaling $1,804,000. In its report, "**REVIEW OF MEDICARE PART A TERMINATION COSTS CLAIMED BY HORIZON BLUE CROSS BLUE SHIELD FOR THE PERIOD AUGUST 2000 THROUGH MAY 2001**," the Office of Inspector General recommended disallowance because; Horizon failed to properly establish a fund or reserve to provide PRBs to retirees, as required by the FAR. Additionally, Horizon failed to fund or otherwise liquidate the assigned PRB costs by the tax return time, as required by the FAR.

Subsequent to this report, on July 14, 2003, Horizon resubmitted its claim for PRB costs in the amount of $2,601,974. On August 13, 2003, Horizon resubmitted that claim plus $50,821 in administrative costs, for a total claim of $2,652,795. Further, Horizon submitted documentation that it would establish an irrevocable grantor trust if it received Government approval for its PRB costs.

OBJECTIVE, SCOPE AND METHODOLOGY

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

We reviewed documentation in support of Horizon's August 13, 2003 claim of $2,652,795 for PRB costs to be incurred subsequent to the termination of the Medicare contract.

We performed this review in conjunction with our audits of pension segmentation[1] and pension costs[2] for a terminated contractor. We used the information obtained from the prior audits in performing this review. We did not review Horizon's internal control structure.

We also used information presented in Horizon's Termination Cost Voucher, which included supporting documentation provided by Horizon's consulting actuaries. We examined Horizon's PRB claim in relation to applicable laws and regulations to ascertain whether Horizon complied with regulatory requirements. We performed audit work at Horizon's corporate office in Newark, New Jersey during April of 2002.

Our audit was performed in accordance with generally accepted government auditing standards, except that we have not included Horizon's views concerning our finding and recommendation. We solicited, but did not receive, a response from Horizon concerning our review. Horizon's failure to comment on our finding and recommendation does not affect the results of our review.

FINDINGS AND RECOMMENDATION

Horizon claimed $2,652,795 in unallowable PRB costs representing estimates to be incurred by Horizon after termination of its Medicare contracts. The claim included reimbursement for unfunded costs and a retroactive change in accounting basis, with immediate recognition of the transition obligation. We found that none of these costs are allowable in accordance with the FAR and therefore the costs are unallowable for Medicare reimbursement.

CRITERIA

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

> **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.

---

[1] Report Number A-07-02-03028, Audit of the Pension Plan at a Terminated Medicare Contractor, Horizon Blue Cross Blue Shield of New Jersey, issued in draft on August 1, 2003.
[2] Report Number A-07-03-03045, Review of Pension Costs Claimed for Medicare Reimbursement by Horizon Blue Cross Blue Shield of New Jersey, issued in final on December 29, 2003.

> **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 PRBs 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. PRB 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 SFAS 106, which established accounting standards for PRBs. The 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 PRBs 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. Additionally, the FAR requires the amortization of the transition obligation amount due to a change in accounting methodology.

Since the 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:

> 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.

CONDITION AND CAUSE

Horizon terminated its Medicare contract on July 31, 2000. Subsequent to contract termination, Horizon submitted a claim for PRB costs of $2,652,795 representing unfunded costs and a retroactive change in accounting basis, with immediate recognition of the transition obligation.

Unfunded Costs

Horizon did not establish an irrevocable trust to cover PRB costs to be paid subsequent to the contract termination date. Horizon intends to establish an irrevocable grantor trust after receiving Government approval of its PRB liabilities. Therefore, Horizon's claim for reimbursement for unfunded costs is not in compliance with the FAR.

Change in Accounting Methodology

Prior to terminating its Medicare contract, Horizon followed its normal practice for Government contracting purposes of claiming PRB costs on the cash basis. Using this methodology, Horizon was reimbursed for actual PRB costs incurred through the contract termination date. However, on August 13, 2003, Horizon claimed $2,652,795 to cover unfunded PRB costs to be paid subsequent to the contract termination date. This claim was calculated as of January 1, 2003 using an accrual basis of accounting and the immediate recognition of the entire transition obligation amount.

The FAR allows contractors the option of electing SFAS 106 accrual accounting, but it requires the amortization of the transition obligation amount. 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. Changes in accounting practice are only permitted on a prospective basis.

The PRB claim is based on a retroactive change from the cash basis to the accrual basis of accounting for the purpose of claiming PRB costs subsequent to Horizon's contract termination. In addition to being an unallowable retroactive change, Horizon's application of the SFAS 106 accrual method of accounting for PRBs is not in compliance with the FAR with regard to treatment of a transition obligation.

CONCLUSION AND RECOMMENDATION

We concluded that PRB costs of $2,652,795 claimed by Horizon are unallowable for Medicare reimbursement. We recommend that Horizon withdraw the August 13, 2003 claim of $2,652,795 for PRB costs.

HORIZON'S COMMENTS

Horizon did not comment on our finding and recommendation. In our draft report to Horizon (issued on February 19, 2004) we requested that Horizon provide us with written comments within 30 days. Horizon did not respond. Additionally, subsequent requests for comments from Horizon remain unanswered.

Horizon's failure to comment on our finding and recommendation does not affect the results of our review.

OTHER MATTERS

We compared the participants valued by Horizon for its PRB claim to the participants that Horizon valued as Medicare segment participants per its defined pension plan. We found that seven of the participants valued for the PRB claim were not valued by Horizon as Medicare segment participants for the defined pension plan. These seven participants had a total PRB liability of $508,402.

In addition, we found four participants valued for the PRB claim that had retired prior to the earliest participant data that Horizon could provide. Consequently, we were unable to verify that these four participants were Medicare segment participants. These participants had total PRB liabilities of $121,505.