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*REPORT TO THE SUBCOMMITTEE ON RETIREMENT AND EMPLOYEE BENEFITS COMMITTEE ON POST OFFICE AND CIVIL SERVICE*

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# Information On Unresolved Audit Exceptions With Federal Employees Health Benefit Carriers

B-164562

Civil Service Commission

*BY THE COMPTROLLER GENERAL OF THE UNITED STATES*

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NOV. 7,1974

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-164562

The Honorable Jerome R. Waldie
Chairman, Subcommittee on Retirement
and Employee Benefits
Committee on Post Office and
Civil Service

Dear Mr. Chairman:

This report is in response to a request from your office for information on unresolved audit exceptions resulting from audits conducted by the U.S. Civil Service Commission of the health insurance carriers for the Federal Employees Health Benefits Program.

We were requested to provide

--the total dollar amount of unresolved audit exceptions as of August 31, 1974;

--an indication of how long these exceptions have been unresolved; and

--the applicability of the Federal Procurement Regulations to the contract between one carrier and the Commission.

On October 17, 1974, we discussed the information we had gathered with your office. During the meeting we were asked for (1) a written summary of the information we had obtained, which was to include an explanation of the areas of disagreement between the Commission and the National Associations of Blue Cross and Blue Shield. In addition, to the extent available, we were to provide the current position of the Commission and the Associations on each issue.

As your office requested, we did not obtain the Commission's or the carriers' formal comments on this report, but the contents were discussed with Commission representatives.

BEST DOCUMENT AVAILABLE

B-164562

We have included, in each section, matters which the Subcommittee may wish to discuss with the Commission. These include:

--The Commission's rationale for not incorporating Government procurement regulations into its contract with the Associations. (See pp. 7 to 9.)

--The Commission's efforts to clarify its audit authority and responsibility regarding the functions of the carriers. (See pp. 10 to 12.)

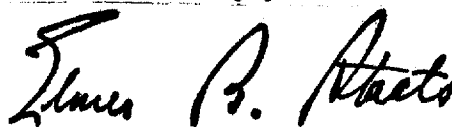
--The Commission's efforts to resolve national issues identified by the Associations. (See pp. 13 to 18.)

--The Commission's efforts to obtain relief from State statutory reserve requirements. (See pp. 19 to 23.)

--The Commission's efforts to resolve, and the potential ramifications of, an accounting statement adjustment by the Associations involving prior period adjustments. (See pp. 24 to 26.)

We do not plan to further distribute the report unless you agree or publicly announce its contents.

Sincerely yours,



Comptroller General
of the United States

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## ABBREVIATIONS

BRIOH — Bureau of Retirement, Insurance, and Occupational Health

CSC — Civil Service Commission

FEHB — Federal Employees Health Benefits

FPRs — Federal Procurement Regulations

GAO — General Accounting Office

LRSP — long-range system planning

OSAGE — Oklahoma Standard Approach to Government Employees

PRAO — Program Review and Audits Office

# UNRESOLVED CIVIL SERVICE COMMISSION AUDIT EXCEPTIONS WITH FEDERAL EMPLOYEES HEALTH BENEFIT CARRIERS

## INTRODUCTION

The Federal Employees Health Benefits (FEHB) program was established by the Federal Employees Health Benefits Act of 1959 (5 U.S.C. 8901) and became effective on July 1, 1960. This program provides hospital, surgical, and medical insurance to Government employees and annuitants and to their dependents or survivors. Participating employees and the Government share the program's cost.

The FEHB Act gave the U.S. Civil Service Commission (CSC) responsibility for program administration. The act authorized CSC to contract for or approve the following four types of plans.

--Service Benefit Plan--a Government-wide plan which provides benefits generally through direct payments to physicians and hospitals.

--Indemnity Benefit Plan--a Government-wide plan which provides benefits by either reimbursements to the employees or, at their request, payments to doctors and hospitals.

--Employee organization plans--plans which are available only to employees who are, or who become, members of the sponsoring organizations and which provide benefits generally by either reimbursement to the employees or, at their request, payments to physicians and hospitals.

--Comprehensive medical plans--plans available only in certain localities that are either group practice plans that provide benefits in the form of medical services by teams of physicians and technicians practicing in their own medical centers or individual practice plans that provide benefits in the form of direct payments to physicians with whom the plans have agreements.

CSC contracts with 42 health insurance carriers to administer the various types of health insurance plans authorized by the FEHB Act. CSC has one contract with the National Associations of Blue Cross and Blue Shield Plans for the Service Benefit Plan and one contract with the Aetna Life Insurance Company acting as the agent for the Indemnity Benefit Plan.

In addition, CSC contracts with 13 employee organization plans and 27 comprehensive medical plans.

These carriers provide health benefits to about 3 million enrollees. The total cost for the FEHB program was $1.4 billion in fiscal year 1973; the Government contributed $577 million and the employees contributed $842 million. The largest single carrier is the Associations, which administer the Service Benefit Plan covering about 60 percent of the enrollees participating in the FEHB program. The Associations in turn contract with 147 local Blue Cross and Blue Shield Plans to provide local administration for the Service Benefit Plan.

Within CSC, the Bureau of Retirement, Insurance, and Occupational Health (BRIOH) is responsible for administering the FEHB program. The Program Review and Audits Office (PRAO) is responsible within BRIOH for CSC's review and audit of the FEHB carriers.

CSC has been responsible for reviewing the FEHB carriers' operations since the program began. In the last few years, CSC has begun to increase its audit activities. For example, in early 1971, the staff of PRAO consisted of 12 persons, including a chief, 9 auditors, and 2 clerks. As of October 1974, the staff had increased to 69, with a chief, 60 auditors, and 8 clerks.

CSC recently changed its procedures for issuing audit reports on the carriers' operations. Before May 1974, CSC issued informal audit inquiries before completing audits to offer the carriers an opportunity to present their positions on specific audit findings, to reduce misunderstandings, and to furnish additional information. Upon completing the audits, CSC prepared final audit reports.

Beginning in May 1974, however, CSC added another step to its audit procedures. CSC now, upon completing an audit, submits draft reports to the carriers and requests comments on its findings, conclusions, and recommendations. CSC then considers the carriers' comments in its final reports.

Most of CSC's audit activities have been directed to the Associations' local plans, since they have the most enrollees. One of the 13 employee organization plans and 13 of the 27 comprehensive medical plans have never been audited by CSC. However, CSC has scheduled all FEHB carriers for audit at least once every 3 years on a cyclical basis.

## CSC'S AUDIT EXCEPTIONS TO CHARGES MADE BY FEHB CARRIERS

CSC has issued 90 audit reports to FEHB carriers since

1971, most of which contain audit exceptions regarding charges made by the carriers to the program.

The 90 reports contained audit exceptions totaling about $10.8 million. Sixty-one of these reports contain about $10 million of questionable charges by the local Blue Cross and Blue Shield plans. The following schedule shows, for 1971 through August 31, 1974, the number of audit reports issued by CSC and the dollar amount of the audit exceptions.

| | Number of audit reports to FEHB carriers | | | Amount of audit exceptions (000 omitted) | | |
|---|---|---|---|---|---|---|
| Calendar year | Local Blue Cross and Blue Shield plans | Other carriers | Total | Local Blue Cross and Blue Shield plans | Other carriers | Total |
| 1971 | 10 | 3 | 13 | $ 116 | $ 10 | $ 126 |
| 1972 | 14 | 4 | 18 | 693 | 49 | 742 |
| 1973 | 21 | 14 | 35 | 3,915 | 460 | 4,375 |
| 1974 | 16 | 8 | 24 | 5,409 | 169 | 5,578 |
| Total | 61 | 29 | 90 | $10,133 | $688 | $10,821 |

Of the 90 audit reports issued by CSC since 1971, 49 contain audit exceptions--amounting to about $10 million--which remained unresolved as of August 31, 1974. Forty-three of these reports pertain to audits of local Blue Cross and Blue Shield plans. The following table shows the unresolved audit exceptions to charges made by carriers to the FEHB program.

| | Reports with unresolved audit exceptions | | | Total amount of unresolved audit exceptions (000 omitted) | | |
|---|---|---|---|---|---|---|
| Calendar year | Local Blue Cross and Blue Shield plans | Other carriers | Total | Local Blue Cross and Blue Shield plans | Other carriers | Total |
| 1971 | 2 | 1 | 3 | $ 33 | $ 5 | $ 38 |
| 1972 | 7 | 1 | 8 | 383 | 4 | 387 |
| 1973 | 18 | 2 | 20 | a/3,719 | 424 | 4,143 |
| 1974 | 16 | 2 | 18 | 5,349 | 168 | 5,517 |
| Total | 43 | 6 | 49 | b/$9,484 | c/$601 | $10,085 |

a/ Includes $938,793 which was refunded by a local plan to the Associations in October 1973; however, this amount was not considered resolved by CSC until September 1974 when it verified that the amount had been credited to the FEHB program.

b/ Appendix II contains more details on these exceptions.

c/ Appendix III shows details concerning CSC's audit exceptions relating to costs of carriers other than Blue Cross and Blue Shield.

In addition, CSC is taking exception to $1.4 million of local Blue Cross and Blue Shield plan charges in draft reports being finalized. Also, CSC has questioned a 1973 accounting statement adjustment for prior period expenses amounting to over $500,000.

CSC is negotiating with the Associations concerning these problems identified by CSC's audits.

--The applicability of the Federal Procurement Regulations (FPRs) to CSC's contract with the Associations.

--The extent of CSC's audit authority and responsibility.

--The resolution of national issues identified by the Associations as having applicability to many local Blue Cross and Blue Shield plans.

--The allowability of charges to the FEHB program for State statutory reserve requirements.

--The appropriateness of accounting adjustments made in 1973 by the Associations for prior years.

The resolution of these problems will significantly affect the allowability of certain charges against the FEHB program. Moreover, the course of CSC's audit activities will depend heavily on the outcome of the negotiations concerning these problems--particularly those related to the applicability of the FPRs to FEHB contracts and the extent of CSC's audit authority and responsibility.

Each of these problems is discussed in the following sections.

## APPLICABILITY OF FPRs TO THE CONTRACT BETWEEN CSC AND THE ASSOCIATIONS

CSC's contracts with the Associations and the comprehensive medical plan providers are the only FEHB contracts in which some type of Government procurement regulations have not been included as part of the contract. According to a CSC official, all the other carriers have been under Government procurement regulations since 1964.

The FPRs were incorporated into the 1973 contract between the Associations and CSC as "a guide" for determining allowable administrative expenses under the contract, subject to any exceptions agreed to by the Associations and CSC in writing.

On December 19, 1972, after the contract negotiations for 1973, the Associations proposed, in a letter, a number of modifications to the FPRs for application to their contract with CSC. That letter stated:

> "We believe that the regulations should be modified, for purposes of this Contract, to the extent that they conflict with generally accepted accounting principles consistently applied by Blue Cross and Blue Shield to 'underwritten' (fixed price) contracts with other large group purchasers of health insurance. This concept involves the proportionate sharing by FEP subscribers of Blue Cross and Blue Shield costs of doing business * * *."

On March 13, 1973, the Associations provided CSC with a summary of their reasons for proposing 17 modifications. On November 8, 1973, because no agreement had been reached on the requested modifications, the Associations submitted to CSC a report prepared by their legal counsel on modifications of the cost principles of the FPRs. This report stated:

> "In our judgment the Government-Wide Service Benefit Plan Contract * * * is not a procurement contract between the Federal Government and Blue Cross and Blue Shield. To the contrary, it is an underwritten group contract of health insurance made available to Federal employees by the Plans through the Blue Cross Association and the National Association of Blue Shield Plans * * *. For that reason, the Contract is not subject to any Federal procurement policies unless the parties to the Contract agree to incorporate those policies by reference."

On February 25, 1974, the Director, BRIOH, requested an opinion from CSC's General Counsel on the applicability of the

FPRs to the contract with the Associations. The Director stated that:

"Before 1973, the contract did not mention FPR's because the Blues refused to agree to such mention, although we informally used them as a guideline."

The Director specifically asked the General Counsel's opinion on

--whether any Federal law makes application of the FPRs to this contract mandatory,

--the handling of exceptions to the FPRs, if the FPRs are to be used merely as guidelines, and

--the handling of exceptions if the FPRs are mandatory to the contract.

As of October 30, 1974, CSC's General Counsel had not issued an opinion on this matter.

On June 26, 1974, the Associations wrote to CSC concerning the application of the FPRs to their contract and stated:

"The remaining unsettled issue for the contract years 1973 and 1974 is the use of the cost principles of the Federal Procurement Regulations in the determination of the administrative expenses chargeable to the Government-wide Service Benefit Plan. Resolution of this issue is extremely important, for it is not feasible to clear out the backlog of audit issues concerning allowable charges until this broader issue is resolved."

* * * * *

"We fully expected the Commission to agree to exceptions which would permit Plans to continue to charge to the Government-wide Service Benefit Plan those types of expenses which had been charged in the past."

In an attachment to their June 26, 1974 letter, the Associations submitted a Memorandum of Law to CSC supporting their position that CSC has the authority to negotiate rates in accordance with insurance industry practice and not in accordance with a rigid application of the FPRs.

According to CSC officials, one principal advantage of the FPRs would be that it would provide a method for settling unresolved audit issues. However, the Associations took a different view in a December 19, 1972, letter to CSC which stated that "The Federal Procurement Regulations do not provide for a procedure to resolve disputes concerning the allowability of any particular expense."

The FPRs do, however, contain a disputes clause. The Chief Administrative Judge, Board of Contract Appeals, General Services Administration, said this clause provides a method of appeal for disputes arising under a contract. He also said that, although some cases reviewed by his board can take anywhere from 30 days to 3 or 4 years, most cases are resolved in less than a year. Over 50 percent of the board's pending cases, he said, were initiated in 1974 and no case went back further than 1973.

Matters for consideration by the Subcommittee

The Subcommittee may wish to discuss with CSC

--the rationale for allowing the Associations' contract to be exempt from some type of Government procurement regulations and

--the status, and reason for the delay, of its General Counsel's opinion on the applicability of the FPRs to the Associations' contract.

CSC'S AUDIT AUTHORITY
AND RESPONSIBILITIES

On February 8, 1974, PRAO issued an informal audit inquiry to the local Blue Cross and Blue Shield plans in Chicago. The inquiry concerned CSC's evaluation of the local plans' programs for controlling the costs of provider health care (hospitals and physicians) as it related to the FEHB program.

This inquiry has raised a question regarding CSC's audit authority. On February 21, 1974, the Vice President of the Associations, responding to the inquiry, questioned CSC's authority to review the local plans' reimbursement agreements with hospitals and physicians. He insisted that

--no further audits of Blue Cross and Blue Shield plans could be started until an audit program was agreed upon,

--no similar informal audit inquiries be issued until such an agreement was reached, and

--the informal inquiry on the Chicago plans be immediately withdrawn pending resolution of the scope of the audit program.

CSC notified the Associations on March 28, 1974, that it was reviewing its authority to audit local plan reimbursement agreements with hospitals and physicians. CSC requested the Associations to reply to the inquiry relating to the Chicago plans.

On April 2, 1974, the Associations answered that they would not respond to this or similar inquiries until CSC'S statutory and contractual authority to conduct this type of audit was clarified and a specific audit program was agreed upon. The Associations requested CSC to confirm that all future audits would be limited to "financial" audits until the contractual authority and scope issues were resolved.

On April 26, 1974, CSC replied, summarizing the agreements reached between the two staffs on the scope of CSC audits and agreeing that CSC would limit its scope of audit to financial areas. In addition, CSC requested that the local plans give CSC certain

information 30 days before an audit and have other specified information available on CSC's request.

In its response on May 29, 1974, the Associations expressed concern that CSC's audit scope moved out of the area of contract compliance and into areas of management prerogative. The Associations stated that:

"The level and/or method of reimbursing a provider is a contractual relationship between the local Blue Cross or Blue Shield plan and the provider and not subject to CSC audit. Of course, any arithmetical errors related to this process can be corrected by CSC."

The Associations also stated that "Whether it is necessary to incur an expense in the performance of this contract is a management prerogative." They also questioned CSC's need for certain items requested, such as the audit reports by internal auditors and a schedule of hospital rates.

On June 25, 1974, the Director of BRIOH responded:

"My purpose in writing to you at this time is to provide our rationale on several specific items, but more importantly , to ask that you reassess what could be perceived as a posture of active resistance to our audit responsibilities under the Federal Employees Health Benefits Act."

On August 27, 1974, the Associations answered that it was in everyone's best interests to define consistent and reasonable working relationships and that CSC's inference that the Associations were assuming a posture of active resistance was a misunderstanding. The Associations agreed to provide certain items to the CSC auditors but stated again that "* * * we must continue to stress that the methods of reimbursement themselves are not subject to evaluation by your auditors." They also pointed out "* * * that the management prerogatives of the carrier are not the proper or fruitful subject of audits, although we will always welcome constructive advice."

On October 10, 1974, CSC presented the Associations with a scope of audit statement and stated that:

> "* * * the scope of audit under discussion represents an interim practice pending resolution of the applicability of the Federal Procurement Regulations to contract CS1039, and resolution of our authority to review contractual relationships between Member Plans and providers vis-a-vis the requirements imposed on the Civil Service Commission by the General Accounting Office."

According to a CSC official, CSC's basis for saying that we impose this requirement on CSC is the Comptroller General's "Standards for Audit of Governmental Organizations, Programs, Activities & Functions." Compliance with these standards, which are guidelines for the use of Federal agencies, is not required by Federal regulations. These standards suggest that a scope of audit include not only financial and compliance auditing but also auditing for economy, efficiency, and achievement of objectives.

As of October 30, 1974, the Associations had not responded to CSC's letter.

## Matters for consideration by the Subcommittee

The Subcommittee may wish to discuss with CSC its efforts to expand its scope of audits to include economy and efficiency reviews which would include audits of the local plans' contractual agreements with the providers, i.e., hospitals and physicians.

CLASSIFICATION OF CERTAIN AUDIT EXCEPTIONS AS NATIONAL ISSUES

The Associations have determined that several of CSC's audit exceptions entail issues which would affect many local Blue Cross and Blue Shield plans and, therefore, should be settled as national issues. Six of the nine issues identified by the Associations have arisen because of audit exceptions already included in CSC's reports. 1/

The Associations agreed in February 1974, to present CSC with position letters on each issue. On May 24, 1974, the Associations stated that they were planning to prepare position letters on two or three national issues each month, starting in July. The Associations stated also that letters covering all nine issues should be completed by the end of September 1974. However, in a July 8, 1974, letter, the Associations stated "the amount of time and effort which will be required in resolving these issues is unknown, but expected to be substantial." As of October 30, 1974, CSC had received only one position letter, dated August 26, 1974.

CSC has taken, or is taking, exception to over $900,000--about $500,000 in final audit reports and $400,000 in draft audit reports--to charges by local Blue Cross and Blue Shield plans which the Associations will not resolve until negotations concerning the national issues are completed. CSC said that these amounts could be substantially larger when applied to all local plans.

The six CSC audit exceptions classified as national issues are discussed below.

Return on investment

Some plans are charging the FEHB program for imputed interest on fixed assets required for conducting business. The

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1/The Associations have identified these three additional national issues requiring attention even though the matters have not been specifically included as exceptions in CSC's reports: (1) interest charges to the program, (2) plan pension system charges, and (3) Associations' pension system charges. CSC has no information available concerning the Associations' rationale for including these matters.

Associations consider this as interest lost to the local plans because of investments in fixed assets rather than investments that would yield a return.

CSC has identified such charges in several audits of local plans and in one report stated:

> "On April 23, 1969, we advised the Associations FEP [FEHB] Director's Office in response to its question on such charges that we did not accept the principle of charging FEP for 'loss' of investment income. The FEP contract * * * provides that only <u>actual</u> costs may be charged to FEP; therefore, imputed expense is not allowable. In addition such costs are prohibited by the Federal Procurement Regulations."

CSC has questioned $337,062 for these charges--$176,742 in final reports and $160,320 in draft reports.

In a response to one of the reports which questioned these charges, the Associations stated:

> "Our Position is that * * * Return on Investment (ROI) costs are allowable and properly chargeable to the Program. Since these have been raised in several CSC audits, they have been identified as Program policy issues and will require resolution at the National Level."

<u>Blue Cross Association enrollment service charge</u>

The enrollment service charge is a charge to the local plans by the Blue Cross Association, which CSC has stated is for soliciting business. The local plans in turn charge a proportionate share of this cost to the FEHB program.

CSC has questioned the enrollment service charge in several audits of Blue Cross plans and in one of its audit reports stated:

> "* * * [this charge is] not allocable to FEP since BCA [Blue Cross Association] is not authorized to solicit FEP business."

As of August 31, 1974, CSC had identified $148,108 for these charges--$10,756 in final reports and $137,352 in draft reports.

In a response to one of CSC's audit reports, the Associations stated that:

> "* * * This finding has been identified as a National Issue and will require resolution at the national level."

Associations' membership dues

The Associations charge membership dues to the various local plans and the local plans, in turn, charge CSC a proportionate share of such dues.

CSC has questioned such charges in several local plans. In an audit report of a local plan in which these charges were questioned, CSC stated:

> "This is not an allowable charge to FEP since FEP is charged directly for BCA and NABSP [National Association of Blue Shield Plans] expenses as reflected in the Annual Accounting Statement."

CSC has identified $193,240 for these charges--$94,151 in final reports and $99,089 in draft reports.

In response to a CSC audit of a local plan in which these charges were questioned, the Associations stated that "* * * Membership Dues are allowable and properly chargeable to the Program."

Tetracycline

Several Blue Cross plans filed a joint suit against Pfizer Chemical Company alleging that the plans had been overcharged for the drug tetracycline. A judgment was rendered in favor of the plans in an amount over $11 million. In several audit reports concerning local plans, CSC requested refunds resulting from the tetracycline settlement. For example, one report stated:

> "The Plan received $116,965 in 1972 as court settlement from tetracycline drug litigation. The proceeds should have been equitably distributed to the various lines of business, which was not done. Since the settlement represents a return of benefits previously

made, each line of business should receive an equitable refund therefrom. We believe that the appropriate time to distribute the funds is in the year received."

CSC has requested refunds of $52,623--$16,334 in final reports and $36,289 in draft reports.

The Associations have not replied to CSC concerning tetracycline refunds.

Long-range system planning (LRSP)

LRSP is a long-range system development project for claims processing. The Associations are developing this project for use in all their lines of business. The Associations charge the local plans a proportionate share of the cost, and the plans, in turn, charge a share of their LRSP costs to FEHB.

One CSC audit report stated that the charges made for LRSP:

"* * * duplicate similar charges made directly to FEP by the Operations Center and Association Headquarters in Chicago for the Operation of the FEP system."

CSC, in 1973, paid $1,498,097 to the Associations for national administrative expenses in addition to payment of administrative expenses incident to local plans. CSC believes that part of this payment goes toward research and development and is willing to pay for research and development costs, but not at both the national and local levels. CSC has identified $35,602 in charges for LRSP--$11,297 in final reports and $24,305 in draft reports.

In their August 26, 1974, position letter concerning this issue, the Associations stated:

"Since the entire cost of LRSP is funded solely by Assessment to Blue Cross and Blue Shield Plans; and since no charges to FEP on behalf of the LRSP project have been made by either the National Associations or the FEP Operations Center; there is no duplication of cost.

"Furthermore, the Operations Center is not engaged in any project which duplicates the effort to develop

a system which is usable by all Plans for all business, which is the objective of LRSP. The National Associations are engaged in the LRSP project but in no other project which duplicates LRSP."

* * * * *

"* * * LRSP is necessary to the continuing effective conduct of the business of the Associations and Blue Cross and Blue Shield Plans (including FEP)."

* * * * *

"* * * the LRSP system will reduce administrative expense through increased productivity, * * * create uniformity in claims administration, and provide more accurate and prompt services * * *."

The Associations said they considered the matter closed and that they trusted that CSC would concur. As of October 30, 1974, CSC had not prepared its response to the letter.

<u>Oklahoma Standard Approach to Government Employees (OSAGE)</u>

OSAGE is a short-term claims-processing system developed specifically for the FEHB program by the local plans in Oklahoma. CSC has taken exception to charges for this system in several audits of local Oklahoma plans.

In an audit report of the local plan in Tulsa, Oklahoma, CSC stated:

"OSAGE duplicates research and development functions and systems cost of the Operations Center and BC/BS headquarters in Chicago * * * ."

CSC has questioned $195,402 for such charges--$184,713 in final reports and $10,689 in draft reports.

The Associations' position letter of August 26, 1974, on LRSP commented that OSAGE

"* * * is a Basic claims processing system being developed for the processing of FEP claims. FEP has

supported this project in its entirety, part of the cost being incurred by the Blue Cross Association, but the bulk of it by local Plans, primarily the Oklahoma Plans. * * * OSAGE is a 'short-term' answer to our current need for a claims processing system designed specifically for FEP."

## Matters for consideration by the Subcommittee

In view of how the settlement of the Associations' national issues could affect the allowability of charges to the FEHB program, the Subcommittee may wish to discuss with CSC its planned timetable for resolving these issues.

CHARGES BY THE ASSOCIATIONS FOR
STATE STATUTORY RESERVE REQUIREMENTS

State statutory reserves are special contingency or epidemic reserves that the laws of some States require health benefit plans to maintain. Though the requirements for annual additions to these reserves differ from State to State, all States requiring reserves provide for discontinuing annual additions when the specified maximums are reached. In 1970, in response to a GAO report, 1/ CSC agreed to review the allowances to local Blue Cross and Blue Shield plans for State statutory reserves.

In a January 25, 1974, audit report to the Associations, CSC stated that the FEHB program was charged by the Associations' Operations Center each year for amounts necessary to meet State statutory reserve requirements. Since the plan began through calendar year 1972 the Operations Center had made charges totaling about $3.7 million for such reserves to the FEHB program for 35 local plans in 10 States.

In its report CSC reached the following conclusions:

"1. That all allowances for further contributions to statutory reserves should be eliminated from the the contract with the plan * * *.

"2. That whenever a state reduces or eliminates the reserve requirement, all past charges for such reserves, plus interest, be promptly credited back to FEP * * *.

"3. That where a state requires a plan to maintain reserves for its total business, funds previously advanced from the Federal program and related interest earned, not returned under point 2 above, be accounted for as FEP assets."

In responding to CSC on February 22, 1974, the Associations pointed out that their position on CSC's proposal to eliminate mandatory State statutory reserves from the

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1/"The Government-wide Service Benefit Plan--Blue Cross and Blue Shield for Federal Employees-Needs Improved Administration," B-164562, October 20, 1970.

contract had been previously set forth in their July 16 and December 7, 1973, letters to CSC. The July 16 letter stated:

> "Such reserves are a legal obligation of all Blue Cross and Blue Shield groups in states where they are required by law or regulation. The purpose of those reserves is to protect Plans' solvency in the event of unusual adverse experience. Although the Public Service Charge constitutes a portion of Plans' mandatory reserve payments, this represents a concession on the part of our Plans. The Public Service Charge, as you know, is intended for other purposes and, to the extent that it is used to satisfy mandatory reserve requirements, there is discrimination against non-federal groups whose subscription rates include factors for both mandatory reserves and a Public Service Charge. Under these circumstances, we cannot agree with your proposal to eliminate mandatory statutory reserve payments as appropriate charges to the contract."

In their February 22, 1974, letter, the Associations said that to eliminate the provision for making mandatory statutory reserve payments from their contract would violate State statutes.

In an April 24, 1974, letter to the Associations regarding the State statutory reserve requirements, CSC stated:

> "Because of your refusal to agree to eliminating from the contract the current statutory reserve provision, and in the interest of bringing 1974 contract negotiations to a conclusion, we will forego final resolution of this matter for 1974 but will pursue it for 1975."

CSC requested that the Associations:

> "* * * ask the appropriate agency in each state where our Program is affected by statutory reserve requirements for relief from those requirements with respect to our Program. We expect the plans to point out to the state agencies that in some jurisdictions statutory reserve requirements have been waived for other national health insurance accounts and

> that, under our Program, a substantial national contingency reserve is maintained in the United States Treasury, a fact which supports our position that the state reserve requirements should not be applied to our Program."

In a May 3, 1974, letter to the Associations, CSC stated that:

> "Records at the Operations Center show that $3,707,672 has been charged to FEP for 35 plans in 10 states, since inception of the program."

CSC also stated that, after a reduction of $127,058 for refunds and $151,319 for an erroneous charge, the net statutory reserve charges to FEHB amounted to $3,429,295.

CSC's May 3, 1974, letter included a schedule of 24 plans for which reserve requirements had been reduced, eliminated, or errors made in computation. This letter stated:

> "We believe that the $1,984,457 total shown on the schedule is legally due FEP and request that these amounts be credited back to the Program within 30 days of this letter. This represents $1,001,101 for charges made before the law was repealed, the requirement reduced, or administratively amended by the State Insurance Commissioners; $666,974 for charges made afterward; and $32,262 for charges computed in error. It also includes $284,120 for interest for local plan use of FEP money on the $1,451,144 distributed to local plans. If no action is taken to adjust the amounts we will refer the matter to our General Counsel for appropriate action."

On May 29, 1974, in responding to CSC's report on State statutory reserve payments, the Associations commented on each of CSC's conclusions:

--Before they request relief from the State insurance departments, the Associations needed further information on CSC's position that the Federal statute 1/ under which the FEHB program operates

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1/The FEHB Act of 1959 (5 U.S.C. 8901).

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provides for contingency reserves and should supersede any State reserve requirement since the purpose is the same.

--The Associations do not accept the premise that, whenever a State reduces or eliminates the reserve requirement, all past charges should be credited back to the FEHB.

--As long as FEHB must make contributions to State mandatory reserves, proprietory rights to such contributions pass to the plan and the State.

The Associations also said that they were conducting a special study of mandatory reserve payments to detect any errors made to plans.

In a July 11, 1974, letter, CSC told the Associations, in regard to contacting State insurance departments for relief from State statutory reserve requirements, that they should advise the State insurance departments that:

"* * * the Contingency Reserve Fund is required by regulation to be maintained at a minimum of one month's (8.33 percent) premium and is dedicated to the use of FEP."

CSC also requested that the Associations not base their approach on the premise that a Federal statute supersedes the State statutes since CSC does

"* * * acknowledge the States' sovereignty in the matter of regulating insurance."

On July 16, 1974, the Director, BRIOH, requested the CSC General Counsel to consider the advisability of instituting legal proceedings against the Associations to recover past charges for State statutory reserve requirements when a State changes or reduces its reserve requirements and to account for contributions to State statutory reserves as an FEHB asset.

On August 12, 1974, CSC's General Counsel recommended that CSC initiate civil action against the Associations on this matter and that BRIOH submit an action memorandum to the Commission requesting authorization to submit this matter to the Department of Justice.

Matters for consideration
by the Subcommittee

In view of the States' requirements for statutory reserves and the Associations' reluctance to request relief from these requirements, as they apply to the FEHB program, the Subcommittee may wish to ask CSC to what extent it has pursued this matter with the States.

1973 ACCOUNTING STATEMENT ADJUSTMENT

In submitting their 1973 accounting statement to CSC, the Associations included adjustments for prior years expenses (audit and other) of $536,572. Because of the contractual limitation on administrative expenses and the Associations' accounting treatment, however, the adjustments for prior years expenses had no effect on the Associations' special reserves. 1/

The Associations had reported administrative expenses incurred of $43.5 million in 1973; however, since the contract limits administrative expenses to a maximum of 4.5 percent of total subscription charges, the maximum amount the Associations could charge to the contract for such charges in 1973 was $37.4 million. In making the prior period adjustments, the Associations reduced the reported expenses of $43.5 million in 1973 with adjusting credits of $257,405 for prior period CSC audit adjustments and $279,167 for adjustments to prior year cost reports. By applying these adjustments to the administrative expenses incurred ($43.5 million) instead of the amount of administrative expenses charged ($37.4 million), the Associations were able to make these adjustments without the FEHB program receiving any benefits, since they did not increase the special reserves held by the Associations for the FEHB program.

An internal memorandum on June 11, 1974, from the Acting Chief, PRAO, to the Director, BRIOH, stated:

> "Because the adjustments pertain to prior periods, when the Blues did not exceed the contract limitation on administrative expenses, they represent an overstatement of administrative expenses for prior periods, and a corresponding understatement of the Plan's special reserves. This means that proper adjustment must increase the Plan's special reserve."

On June 17, 1974, CSC requested the Associations to submit an amended accounting statement for 1973 to make the adjustments for prior years after the contract limitation on administrative expenses is applied to correctly increase the ending special reserve. The

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1/The special reserves represent the excess of income over all allowable charges and are to be returned to CSC upon termination of the contract after settlement of accrued liabilities and certain liquidation expenses.

Associations responded on June 27, 1974, that they did not agree with CSC's conclusion that the ending special reserve was understated by more than $500,000. The Associations stated that:

> "In our final accounting statements we have consistently reported Program incurred costs to be the current period payments plus or minus prior year adjustments plus Program accruals for the current period. In 1973, we had no Program accruals but did incur expenses, which were excess to the contract limitation."

The Associations also stated:

> "In summary, since no change has been made in our treatment of prior year adjustments in our final accounting statement and we see no reason to make such a change, an amended statement is not required."

On June 28, 1974, CSC notified the Associations that CSC was withholding the $536,572 overcharge in prior years administrative expenses from the current year's contingency reserve payment. CSC also noted that it still expected an amended report for 1973.

On July 17, 1974, CSC told the Associations that it would continue to withhold final settlement of the contingency reserve payment until it received a satisfactory calendar year 1973 accounting statement. In commenting on the Associations' letter of June 27, 1974, CSC stated:

> "You did not provide any support for the propriety of this treatment, basing your conclusions solely on your past treatment of adjustments. You apparently failed to realize that your past accounting treatment did not distort operations, as the ending reserve was properly stated. However, due to your Administrative expenses exceeding the contract limitation in 1973, your proposed treatment distorts the Plan's reserves held for FEP and therefore should be corrected."

On August 14, 1974, the Associations replied:

> "Our conclusion remains the same; there is no precedent in the instructions of prior years

for treating Final Accounting Statements in the manner you propose for 1973 and in addition, your proposal would violate conventional accounting practice."

The Associations enclosed a memorandum of law with their August 14 letter which was prepared by their legal counsel which set forth the basis for their position. The Associations also noted that the $536,572 had been wrongfully withheld and requested that their contingency reserve payment be promptly restored.

CSC has currently referred this matter to its General Counsel. The General Counsel is to review the prior period adjustments to provide CSC with an opinion on the merits of CSC's position.

Matters for consideration by the Subcommittee

The settlement of this issue could establish a precedent for accounting for prior years adjustments--including those which might be made as a result of resolving CSC's unresolved audit exceptions. Accordingly, the Subcommittee may wish to explore with CSC the ramifications if the Associations are permitted to account for the adjustments in this matter.

## MAJOR AUDIT EXCEPTIONS IDENTIFIED IN CSC'S AUDITS OF THE ASSOCIATIONS' LOCAL PLANS

| Nature of exception | Amount |
|---|---|
| | (000 omitted) |
| National issues | $ 494 |
| State statutory reserve requirments | 3,429 |
| Hospital refunds not credited to FEHB | 1,296 |
| Interest lost by FEHB | 186 |
| Charges for advertising and public relations | 50 |
| Charges for data processing systems and studies | 274 |
| Lack of accounting support (hospital payments for 1 plan) | 1,300 |
| Charges to operations center exceeding payments to hospitals | 1,281 |
| Miscellaneous | 1,174 |
| | $9,484 |

OTHER FEHB CARRIERS WITH UNRESOLVED

AUDIT EXCEPTIONS AS OF AUGUST 31, 1974

| Carrier | Date of Report | Unresolved CSC audit exceptions: Nature of exception | Amount | Total |
|---|---|---|---|---|
| Hawaii Medical Service Association | 3-28-74 | Advertising | $ 17,888 | $ 17,888 |
| Special Agents Mutual Benefit Association | 5-13-74 | Selling expenses | 147,630 | |
| | | Claim drafts | 1,965 | 149,595 |
| American Federation of Government Employees | 2-12-73 | Printing allocation | 781 | |
| | | Printing, advertising and promotion | a/4,257 | 5,038 |
| National Postal Union Plan | 7- 9-73 | Promotional and advertising expense | 1,204 | |
| | | Postage charges | 2,762 | |
| | | National convention and executive board expenses | 27,157 | |
| | | Board meeting expenses | 3,121 | |
| | | Charges for retirement plan | 304,285 | |
| | | Idle facilities | 55,125 | |
| | | Merger expenses | 2,004 | |
| | | Unidentified expenses | 75 | |
| | | First-class air travel | 390 | |
| | | Large salary increases | 22,000 | |
| | | Claim paid twice | 140 | |
| | | Claim paid when claimant had other insurance | 888 | |
| | | Paid for Whirlpool machine | 209 | $419,360 |
| United Federation of Postal Clerks | 11-13-72 | Lease option | 3,000 | |
| | | First-class air travel | 674 | 3,674 |
| National League of Postmasters | 3-24-71 | Gift charge | 391 | |
| | | Prior audit adjustment credit due | 4,795 | 5,186 |
| Total | | | | $600,841 |

a/ This amount was shown as unresolved in CSC records as of 8-31-74. On 10-29-74 a CSC official said this amount had been credited to FEHB by the carrier in their 1973 accounting statement.

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