DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date MAY 4 1998

From for Michael Mangano
June Gibbs Brown
Inspector General

Subject Review of Pension Plan at a Terminated Medicare Contractor, Rocky Mountain Health Care Corporation (A-07-97-01234)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

This is to alert you to the issuance of our final audit report on Wednesday, May 6, 1998, identifying about $4.1 million in excess pension assets at Rocky Mountain Health Care Corporation (Rocky Mountain) which should be remitted to Medicare because of the closing of Rocky Mountain's Medicare segment of their pension plan. A copy is attached and copies of the report have been distributed to your staff for adjudication of the finding.

Rocky Mountain was a Medicare Part A and B contractor until their contracts were terminated in 1994 and 1995, respectively. As part of their contract, they are allowed to allocate employee pension costs to Medicare for payment. Regulations and the Medicare contracts provide, however, that pension gains which occur when a Medicare segment closes should be credited to the Medicare program. Accordingly, we are recommending that Rocky Mountain remit about $4.1 million in excess pension assets to the Medicare program.

Rocky Mountain disagreed with our recommendation because they believed that our audit report: (1) failed to recognize that the amount of any pension cost adjustment is severely constrained by "Closing Agreements" and the effective date of Cost Accounting Standards No. 413; (2) misstated the pension assets attributable to the Medicare segment of their pension plan; and (3) misstated the actuarial liabilities attributable to the Medicare segment.

Our calculations were based on applicable regulations, the terms and underlying principles of the Medicare contracts, Rocky Mountain's historical practices, and actuarial data provided by Rocky Mountain's consulting actuary. The Health Care Financing Administration, Office of the Actuary, reviewed our report, including Rocky Mountain's comments, and agreed with our analysis and resultant recommendation.

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

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF PENSION PLAN AT A TERMINATED MEDICARE CONTRACTOR, ROCKY MOUNTAIN HEALTH CARE CORPORATION

JUNE GIBBS BROWN
Inspector General

MAY 1998
A-07-97-01234

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Office of Audit Services

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

CIN A-07-97-01234

Ms. Pat Miller
Manager of Cost Accounting
Rocky Mountain Health Care Corporation
700 East Broadway
Denver, Colorado 80273

Dear Ms. Miller:

This report provides the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review titled *Review of Pension Plan at a Terminated Medicare Contractor, Rocky Mountain Health Care Corporation*. The purpose of our review was to determine the excess pension assets that should be remitted to Medicare by Rocky Mountain Health Care Corporation (Rocky Mountain) because of the termination of the Medicare contractual relationship in 1995.

We computed excess Medicare pension assets of $4,079,171 as of January 1, 1996, which Rocky Mountain should remit to the Federal government. Rocky Mountain believed that elements of our calculations resulted in an overstatement of the recommended refund. Rocky Mountain's response is included in its entirety as Appendix B. Appendix C contains the Health Care Financing Administration (HCFA), Office of Actuary's comments on Rocky Mountain's response.

INTRODUCTION

BACKGROUND

Rocky Mountain administered Medicare Part B operations under cost reimbursement contracts until the contractual relationship was terminated in 1994 and Medicare Part A operations until the contractual relationship was terminated in 1995. In claiming costs, contractors were to follow cost reimbursement principles contained in the Federal Procurement Regulations (FPR), which were superseded by the Federal Acquisition Regulations (FAR), the Cost Accounting Standards (CAS), and the Medicare contracts.

Since its inception, Medicare has paid a portion of the annual contributions made by contractors to their pension plans. These payments represented allowable pension costs under the FPR and/or the FAR. In 1980, both the FPR and Medicare contracts incorporated CAS 412 and 413.

The CAS 412 regulates the determination and measurement of the components of pension costs. It also regulates the assignment of pension costs to appropriate accounting periods. The CAS 413 regulates the valuation of pension assets, allocation of pension costs to segments of an organization, adjustment of pension costs for actuarial gains and losses, and assignment of gains and losses to cost accounting periods.

The HCFA incorporated segmentation requirements into Medicare contracts starting with Fiscal Year 1988. The contractual language specifies segmentation requirements and also provides for the separate identification of the pension assets for a Medicare segment.

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

In our report titled *"Audit of Medicare Contractor's Segmented Pension Costs Rocky Mountain Health Care Corporation"*, dated May 6, 1997 (CIN A-07-96-01185) we addressed the computation of the asset fraction, the identification of the segment's assets as of January 1, 1986, and updated the segment's assets to January 1, 1995.

Rocky Mountain's Medicare Part B contract was terminated effective October 1, 1994, while the Medicare Part A contract was terminated effective December 29, 1995. Contract terminations are addressed by CAS 9904.413-50(c)(12), which provides criteria involving the closure of a segment. It states:

> *"If a segment is closed, the contractor shall determine the difference between the actuarial liability for the segment and the market value of the assets allocated to the segment, irrespective of whether or not the pension plan is terminated....The calculation of the difference between the market value of the assets and the actuarial liability shall be made as of the date of the event that caused the closing of the segment. If such a date cannot be readily determined, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date."*

Medicare contracts specifically prohibit any profit (gain) from Medicare activities. Therefore, according to the contract, pension gains which occur when a Medicare segment terminates should be credited to the Medicare program. In addition, FAR addresses dispositions of gains in situations such as contract terminations. When excess or surplus assets revert to a contractor as a result of termination of a defined benefit pension plan, or such assets are

constructively received by it for any reason, the contractor shall make a refund or give credit to the Government for its equitable share (FAR, section 31.205-6(j)(4)).

OBJECTIVE, SCOPE, AND METHODOLOGY

We made our examination in accordance with generally accepted government auditing standards. Our objective was to determine the amount of excess assets that should be remitted to Medicare as a result of the contract terminations. Achieving the objective did not require a review of Rocky Mountain's internal control structure.

Rocky Mountain's Medicare Part B contract was terminated effective October 1, 1994, while the Medicare Part A contract was terminated effective December 29, 1995. Due to the two termination dates, we agreed with Rocky Mountain that January 1, 1996 would be an appropriate measurement date for the closing of the segment. We therefore reviewed Rocky Mountain's update of Medicare assets from January 1, 1995 to January 1, 1996. Rocky Mountain identified total pension assets of $56,589,152 and Medicare segment assets of $5,130,336 as of January 1, 1996.

In performing the review, we used information provided by Watson Wyatt Worldwide, Rocky Mountain's consulting actuary. The information included liabilities, normal costs, contributions, and earnings. We reviewed Rocky Mountain's accounting records, pension plan documents, and annual actuarial valuation reports. Using these documents, we verified Rocky Mountain's update of Medicare segment assets to January 1, 1996. The HCFA pension actuarial staff reviewed our methodology and calculations.

Site work was performed at Rocky Mountain's corporate office in Denver, Colorado. We performed additional audit work in our OIG, OAS Jefferson City, Missouri field office.

FINDING AND RECOMMENDATION

When Rocky Mountain's contractual relationship with Medicare ended, Medicare's share of the excess pension assets was $4,079,171, which we are recommending be remitted to HCFA. To determine Medicare's share it was necessary to (1) update segment assets to January 1, 1996, and (2) calculate the excess Medicare assets. These elements are described in detail in the following sections.

Updating Segment Assets

As of January 1, 1996, Rocky Mountain determined Medicare segment assets at $5,130,336. We identified Medicare segment pension assets of $4,550,107 as of January 1, 1996. The decrease of $580,229 resulted from: (1) assigning pension contributions equitably to the Medicare segment ($69,793 decrease), (2) assigning investment earnings equitably to the Medicare segment ($9,198 increase), and (3) adjusting for participants that moved out of the Medicare segment ($519,634 decrease).

Pension Contributions

For plan year 1995, Rocky Mountain's consulting actuary assigned $69,793 of the 1995 contribution to the Medicare segment. Due to the existence of prepayment credits and a negative CAS pension cost for 1995, it was not necessary that any of the 1995 contribution be assigned to the Medicare segment. As a result, Rocky Mountain overstated Medicare segment assets by $69,793.

Investment Earnings

Historically, Rocky Mountain's update methodology allocated investment earnings to the Medicare segment based on the ratio of beginning of year market value of Medicare assets to beginning of year market value of total assets. We identified both a discrepancy between the investment earnings as reported in the 1996 actuarial valuation report and the update of Medicare segment assets and a mathematical discrepancy in the allocation methodology. Correcting for both these discrepancies in our update increased the Medicare segment assets by $9,198.

Participant Transfers

Due to the termination of the Medicare contracts, we transferred all plan participants out of the Medicare segment as of December 31, 1995. Our transfer adjustment was a transfer out of $1,461,117. For that same period, Rocky Mountain's transfer adjustment was a transfer out of $941,483. As a consequence, Rocky Mountain overstated Medicare segment assets by $519,634 ($1,461,117 less $941,483).

Calculation of Excess Medicare Assets

Adjusting the Medicare segment pension assets to reflect the cumulative effect of the above corrections decreased Rocky Mountain's determination of $5,130,336 by a total of $580,229 to $4,550,107 as of January 1, 1996. See Appendix A.

The excess segment assets as of January 1, 1996 were $4,550,107. However, because the segment was not 100 percent devoted to Medicare operations, only a portion of the excess segment assets are attributable to Medicare.

To arrive at Medicare's share of the excess assets, we determined the aggregate percentage of the segment, to be 89.65 percent as follows:

Year	Medicare Salaries	Total Salaries
1986	$ 5,694,448	$ 6,284,416
1987	6,144,834	6,908,226
1988 *	4,662,771	5,386,759
1989 *	4,537,254	5,048,597
1990	8,107,686	8,828,305
1991	8,014,774	8,828,305
1992	8,435,169	9,541,501
1993	9,102,345	9,933,495
1994	9,143,027	10,178,160
1995	4,819,468	5,512,977
Total	$ 68,661,776	$ 76,585,042

($68,661,776 / $76,585,042 = 89.65 percent)

* Salary information not available for New Mexico for 1988 and 1989.

After applying the Medicare percentage of 89.65 to excess segment assets of $4,550,107, the resulting amount of $4,079,171 represents the portion attributable to Medicare. Because of the termination of the Medicare contracts, this excess must be remitted to the Federal government.

Recommendation:

We recommend that Rocky Mountain:

Remit $4,079,171 to HCFA.

Auditee Response

Rocky Mountain's comments are summarized in the following paragraphs and presented in detail on Appendix B.

Rocky Mountain believed that our audit report: (1) failed to recognize that the amount of any pension cost adjustment is severely constrained by "Closing Agreements" and the effective date of CAS 413; (2) misstated the pension assets attributable to the Medicare segment; and (3) misstated the actuarial liabilities attributable to the Medicare segment.

According to Rocky Mountain, the amount of any pension cost adjustment is severely constrained by the closing agreements and the effective date of CAS 413. They assert that the CAS 413 and binding closing agreements limit any adjustment under CAS 413.50(c)(12) to the amount of the Medicare segment's reimbursed pension costs that are not covered by a "Closing Agreement". And, any pension cost adjustment under CAS 413.50(c)(12) may not exceed the Medicare segment's pension costs that were actually reimbursed by HCFA after CAS 413 first became applicable to the Medicare contracts.

Rocky Mountain also believes that the report misstates the amount of the pension assets attributable to the Medicare segment. Rocky Mountain asserted that we improperly allocated pension contributions to the Medicare segment for 1986, and that we should not have transferred any of the pension assets attributable to inactive Medicare employees. Additionally, Rocky Mountain contends that we should not have transferred all of the active employees from the Medicare segment prior to calculating the segment closing adjustment. However, Rocky Mountain believes that for those active employees for whom asset transfers were appropriate, we should have also transferred the surplus assets associated with such employees. And, the expenses and earnings attributed to the Medicare segment should be adjusted to account for the asset adjustments described above.

According to Rocky Mountain, our report misstates the amount of the actuarial liabilities attributable to the Medicare segment. Rocky Mountain maintains that a projected benefit measure of liability should be used for those active Medicare employees who transferred to the non-Medicare segment following the termination of the segment. Furthermore, they assert that all of the actuarial liabilities should be valued using the discount rate promulgated by the Pension Benefit Guaranty Corporation (PBGC), and that the actuarial liability should reflect the present value of the future administrative expenses.

OIG Comments

Our comments are summarized in the following paragraphs. The HCFA, Office of the Actuary's detailed comments on Rocky Mountain's response are presented on Appendix C.

Rocky Mountain's arguments ignore the terms and underlying principles of their Medicare contracts. The Medicare contracts required that the calculation of and accounting for pension costs be governed by the FAR, and CAS 412 and 413. The HCFA incorporated segmentation requirements into Medicare contracts starting with Fiscal Year 1988. Additionally, the contracts defined a Medicare segment, and specified the methodology for the identification and initial allocation of pension assets to the Medicare segment.

The contracts' methodology for establishing the initial Medicare segment assets was negotiated and agreed to by HCFA and the Medicare contractors. The objective of the methodology was to fairly represent the events of prior periods. Therefore, any over or under funding of the pension plan in prior years was captured in the initial allocation of the segment's pension assets, regardless of the status of any closing agreements for those prior years.

The contracts also required that the Medicare segment assets be updated for each year after the initial allocation in accordance with CAS 413. The segment's pension assets were to be increased by contributions and earnings, and decreased by plan expenses and benefit payments in the same manner as the total pension plan.

Rocky Mountain implemented the Medicare contract provisions by identifying a Medicare segment, establishing the segment's initial pension assets as of January 1, 1986 , and updating the segment's pension assets from 1986 through 1995.

According to CAS 413, when a segment is closed, the contractor must determine the difference between the actuarial liability for the segment and the market value of the assets allocated to the segment. That comparison of the segment's market value of assets and actuarial liability is to be made as of the date of the event that caused the closing of the segment, such as a contract termination. Therefore, the computation is made as of a single point in time irrespective of what has transpired previously. If the segment's market value of assets exceeds the actuarial liability at that point in time, then a gain has occurred.

The Medicare contracts specifically prohibit any profit (gain) from Medicare activities. Therefore, according to the contract, pension gains which occur when a Medicare segment terminates should be credited to the Medicare program. Additionally, the FAR addresses dispositions of gains in situations such as contract terminations. According to the FAR, when excess or surplus assets revert to a contractor as a result of termination of a defined benefit pension plan, or such assets are constructively received by it for any reason (such as a segment closing), the contractor should make a refund to the Government for its equitable share.

We find no provisions in Rocky Mountain's Medicare contracts, the CAS, or the FAR to support Rocky Mountain's assertion that "the amount of any pension cost adjustment is severely constrained by the closing agreements and the effective date of CAS 413."

Rocky Mountain asserts that our report misstates the pension assets attributable to the Medicare segment and that we created or used methodologies, practices, data, or information of our own. However, this was not the case. We reviewed, analyzed, and reported on information prepared and provided by Rocky Mountain, and/or their consulting actuary. Additionally, our update methodologies were the same as those that were historically, and consistently, used by Rocky Mountain, and/or their consulting actuary. In fact, the update methodologies used by Rocky Mountain are the same methodologies that we have found during audits of sixteen other Medicare contractors that employed the same consulting actuary.

Rocky Mountain maintains that we improperly allocated pension contributions to the Medicare segment for 1986, using normal costs and accrued liabilities. According to Rocky Mountain, the use of this allocation method resulted in an overstatement of the pension assets attributable to the Medicare segment.

We did assign pension contributions of $90,043 to the Medicare segment for 1986 based on normal costs and accrued liabilities of the segment participants. However, Rocky Mountain used this same methodology and assigned pension contributions of $94,370 to the Medicare segment for 1986. Additionally, in their update of segment assets, Rocky Mountain described the 1986 Medicare segment pension contribution as "Charges to Medicare".

Rocky Mountain contends that our report should not transfer any of the pension assets attributable to inactive Medicare employees. According to Rocky Mountain, since no separate segment devoted exclusively to inactive plan participants existed, no transfers of the pension assets or liabilities attributable to such participants should have been made. They believe that the Medicare segment's assets should be recalculated without such transfers.

Rocky Mountain also contends that for those active employees for whom asset transfers were appropriate, our report should have also transferred any surplus assets associated with such employees. According to Rocky Mountain, we computed transfer adjustments without first determining whether such adjustments were required. Additionally, if such transfer adjustments were required we should have transferred any surplus assets associated with the transferred active participants.

We did transfer Medicare segment participants to the inactive or "other" segment when the participants retired or terminated with a vested benefit. We also did not include any inactive participants in the calculation of the asset fraction. However, this was not a methodology that we created. Rocky Mountain used this same methodology in their calculation of the asset fraction and in their update of segment assets from 1986 through 1995.

We did compute transfer adjustments, for active participants that moved between the Medicare and other segments, for each year 1986 through 1995, and we did limit the amount of assets transferred to 100 percent of the liability transferred. However, this again was not a methodology that we created. Instead, it is the same methodology that Rocky Mountain historically followed.

The CAS only requires transfer adjustments if the transfer is sufficiently large to distort the segment's ratio of fund assets to actuarial liabilities. However, the CAS does not prohibit transfer adjustments absent such distortion. Rocky Mountain computed transfer adjustments for each year of the update period, 1986 through 1995. If they had not done so, we would have performed an analysis to determine if transfer adjustments were required. Since Rocky Mountain made transfer adjustments every year, we merely followed their historical practices. As noted above, we found this same methodology during the audits of sixteen other Medicare contractors employing the same consulting actuary.

Rocky Mountain believes that our report should not have transferred all of the active employees from the Medicare segment prior to calculating the segment closing adjustment. Instead, they believe that such employees should have been treated as part of the Medicare segment for purposes of calculating any segment closing adjustment. Additionally, they do not believe that it was appropriate to calculate the segment closing adjustment as of January 1, 1996. However, they acknowledge that it may be appropriate to use certain data from the January 1, 1996 valuation to compute the closing adjustment.

We did transfer the Medicare segment's remaining active participants out of the segment as of December 31, 1995 because these employees were no longer performing Medicare operations. However, because we transferred assets equal to the participants' actuarial liability, the transfer adjustment had no effect on the segment closing calculation. In regard to the settlement date, January 1, 1996 was used because the valuation data needed to complete the calculation was readily available for this point in time. This matter was discussed at length with Rocky Mountain personnel. They at no time prior to their written response voiced any disagreement with the use of this measurement date. Additionally, they have not provided a valid argument for the use of any other date. Furthermore, we do not believe that the use of any other appropriate date would have a material impact on the segment closing adjustment.

Rocky Mountain contends that earnings and expenses allocated to the Medicare segment should be adjusted to account for the asset adjustments that they have proposed in their response. The allocation of earnings and expenses to the Medicare segment are dependent upon all other cost allocation factors. However, since we disagree with the other adjustments proposed by Rocky Mountain, no adjustment to earnings and expenses is required.

We found no merit in Rocky Mountain's assertions that our report "...misstates the amount of the pension assets attributable to the Medicare segment."

Rocky Mountain contends that our report misstates the amount of the actuarial liabilities attributable to the Medicare segment. According to Rocky Mountain, we should have used a projected measure of liability for active employees, and should have used the PBGC discount rate to value those liabilities. Additionally, they believe that the actuarial liability of the Medicare segment should have reflected the present value of future administrative expenses.

We do not agree with the use of a projected measure of actuarial liability for the purposes of calculating a segment closing adjustment. The projected benefit method is allowable when there is a future benefit relationship. An underlying principle of the CAS and Government contract accounting in general, has been that there must be a causal/beneficial relationship between incurring a cost and the performance of a contract before that cost can be allocated to and allowed under that contract. When a segment closes, there is an end to the causal/beneficial relationship between future pay raises and the Government contracts. Thus it is inappropriate to recognize future salary increases when determining the CAS 413.50(c)(12) segment closing adjustment.

We do not agree that the PBGC discount rate should have been used to value actuarial liabilities. The PBGC may only invest its premiums in special securities issued by the U.S. Treasury, which yield significantly lower expected investment returns than that of a professionally managed trust. In addition, the methodology used to develop the PBGC rates produces extremely conservative rates. This level of extreme conservatism is only appropriate

for an insurer that must guarantee the benefit liability of plan sponsors in critical financial distress. When the pension plan and trust continue, the PBGC assumptions are inappropriate and unreasonable.

The actuarial liability used to determine the CAS 413.50(c)(12) adjustment was provided by Rocky Mountain's actuary, and it was based on the interest and mortality valuation assumptions used since 1985. Additionally, the actuarial liability provided by Rocky Mountain's actuary did include assumptions and methods to provide for administrative expenses. We made no adjustments to remove or change the recognition of administrative expenses.

INSTRUCTIONS FOR AUDITEE RESPONSE

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

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

Sincerely,

Barbara A. Bennett

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

Enclosures

Ms. Mary Kay Smith
Regional Administrator, Region VIII
Health Care Financing Administration
Federal Office Bldg., 1961 Stout St., Room 522
Denver, Colorado 80294-3538

ROCKY MOUNTAIN HEALTH CARE CORPORATION

CIN: A-07-97-01234

STATEMENT OF MEDICARE PENSION ASSETS
JANUARY 1, 1995 TO JANUARY 1, 1996

Description		Total Company	Other Segment	Medicare
Assets January 1, 1995	1/	**$45,416,804**	**$40,480,743**	**$4,936,061**
Contributions	2/	1,839,764	1,839,764	0
Earnings	3/	11,952,978	10,653,885	1,299,093
Benefits	4/	(2,358,653)	(2,163,170)	(195,483)
Expenses	5/	(261,741)	(233,294)	(28,447)
Transfers	6/	0	1,461,117	(1,461,117)
Assets January 1, 1996		**$56,589,152**	**$52,039,045**	**$4,550,107**
Assets Rocky Mountain	7/	**56,589,152**	**51,458,816**	**5,130,336**
Variance	8/	**0**	**580,229**	**(580,229)**

FOOTNOTES

1/ We obtained the total assets as of January 1, 1995 from our report titled "Review of Medicare Contractor's Pension Segmentation, Rocky Mountain Health Care Corporation" (CIN: A-07-96-01185) and Rocky Mountain's update of Medicare segment assets.

2/ We obtained total contribution amounts from the 1996 actuarial valuation report. Due to the existence of a prepayment credit and a negative CAS pension cost for the Medicare segment it was not necessary to assign any of the contribution to the Medicare segment.

3/ Rocky Mountain provided earnings amount that we verified to the 1996 actuarial valuation report. We allocated earnings to the Medicare segment based on the ratio of the beginning of the year market value of Medicare assets to market total assets. Rocky Mountain used this same methodology.

ROCKY MOUNTAIN HEALTH CARE CORPORATION

CIN: A-07-97-01234

STATEMENT OF MEDICARE PENSION ASSETS
JANUARY 1, 1995 TO JANUARY 1, 1996

4/ Rocky Mountain provided the benefit payment amount and we verified it to the 1996 actuarial valuation report. We used Rocky Mountain's benefit payments for the Medicare segment.

5/ Rocky Mountain provided the administrative expense amount and we verified it to the 1996 actuarial valuation report. We allocated administrative expenses to the Medicare segment on the ratio of the beginning of year market value of Medicare assets to total assets. Rocky Mountain used this same methodology.

6/ We identified participant transfers out of the segment by comparing annual participant valuation listings provided by Rocky Mountain. The listings contained the actuarial liability of each participant at year-end. Our transfer adjustment considered each participant's actuarial liability and the funding level of the segment from which the participant transferred. We calculated the funding level as the assets divided by the liabilities. If the funding level ratio was greater than one, we transferred assets equal to the participant's liability.

7/ We obtained the total assets as of January 1, 1996 from Rocky Mountain's update of assets provided by its actuary.

8/ The asset variance represents the difference between the OIG calculations of assets as of January 1, 1996 and the assets calculated by Rocky Mountain's actuary.

BlueCross BlueShield of Colorado

An Independent Licensee of the Blue Cross and Blue Shield Association

700 Broadway
Denver, Colorado 80273-0002

September 10, 1997

Ms. Barbara A. Bennett
Regional Inspector General for Audit Services, Region VII
Department of Health and Human Services
Room 284A
601 East 12th Street
Kansas City, Missouri 64106

RE: Comments of Rocky Mountain Health Care Corp.
Concerning Draft Audit Report No. CIN A-07-97-01234

Dear Ms. Bennett:

Thank you for affording Rocky Mountain Health Care Corp. ("RMHCC") this opportunity to comment on draft Audit Report No. CIN A-07-97-01234 ("the draft audit report"), and for extending the due date for the submission of our comments. We appreciate the cooperation and assistance rendered to us by your auditors.

The draft audit report recommends that RMHCC remit $4,079,171 to the Federal government. According to the report, that amount is said to represent "excess Medicare pension assets . . . as of January 1, 1996," which purportedly arose from pension cost reimbursements made by the Health Care Financing Administration ("HCFA"). Those reimbursements were made to the following contractors: (1) Rocky Mountain Hospital and Medical Service (dba Blue Cross Blue Shield of Colorado ("BCBSCo")) under a series of Medicare Part A and Part B contracts; and (2) Blue Cross Blue Shield of New Mexico, Inc., ("BCBSNM") under a series of Medicare Part A contracts.[1/] The draft audit report contends that HCFA is entitled to the recommended remittance by Cost Accounting Standard ("CAS") 413.50(c)(12), which provides for an "adjustment of previously-determined pension costs" upon the closure of a segment.

We have carefully reviewed the draft audit report with our actuaries and counsel, each of whom is knowledgeable concerning Medicare pension cost matters. Based upon our review to date, and as explained in detail below, we believe that the draft audit report is marred by the following

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1/ Since 1987, BCBSCo and BCBSNM have jointly owned RMHCC, which provided certain administrative services to BCBSCo and BCBSNM.

flaws: (1) the report fails to recognize that the amount of any pension cost adjustment is severely constrained by "Closing Agreements" and the effective date of CAS 413; (2) it misstates the pension assets attributable to the Medicare segment; and (3) it misstates the actuarial liabilities attributable to the Medicare segment. We may identify additional flaws or modify our analysis as our review progresses.

Because these flaws caused the recommended remittance to be significantly overstated, we request that the amount of the recommended remittance, if any, be recalculated in light of the comments set forth below. We would be pleased to discuss the draft audit report, our comments, and our suggested recalculation with you or your staff prior to the issuance of your final audit report.

I. THE AMOUNT OF ANY PENSION COST ADJUSTMENT IS SEVERELY CONSTRAINED BY THE CLOSING AGREEMENTS AND THE EFFECTIVE DATE OF CAS 413.

The $4 million remittance recommended by the draft audit report is significantly overstated, even assuming that the amounts of pension assets and actuarial liabilities attributable to the Medicare segment were correctly determined (which they were not). This is so because the report fails to recognize that: (1) a negative "adjustment of previously-determined costs" under CAS 413.50(c)(12) may not exceed the amount of the Medicare segment's pension costs that were actually reimbursed by HCFA for fiscal years where the allowable pension costs were not finally determined by a "Closing Agreement"; and (2) any such adjustment may not exceed the amount of the Medicare segment pension costs that were actually reimbursed by HCFA for the fiscal years after CAS 413 first became applicable to the Medicare contracts.

A. CAS 413 And Binding Closing Agreements Limit Any Adjustment Under CAS 413.50(c)(12) To The Amount Of The Medicare Segment's Reimbursed Pension Costs That Are Not Covered By A "Closing Agreement."

The draft audit report contends that RMHCC had "excess Medicare pension assets of $4,079,171 as of January 1, 1996," and recommends that RMHCC remit that amount to the Federal government under the authority of CAS 413.50(c)(12). However, the report fails to recognize that CAS 413.50(c)(12) does *not* entitle the government to excess pension assets held in

RMHCC's pension plan upon the closure of a segment.[2/] Instead, that provision provides simply for an "adjustment of previously-determined pension costs" -- the pension costs reimbursed by HCFA under Medicare contracts in prior years -- when a segment closes. *See* CAS 413.50(c)(12).

This distinction is crucial. The amount of a negative "adjustment of previously-determined pension costs" under CAS 413.50(c)(12) cannot exceed the total amount of the pension costs that are being "adjusted," that is, the pension costs of the Medicare segment that were previously reimbursed by HCFA. A demand for the remittance of excess pension assets in an amount that vastly exceeds the total amount of the segment's pension costs that were reimbursed by HCFA cannot meaningfully be said to be an "adjustment" of those reimbursed costs.

Moreover, the report fails to recognize that many of the Medicare segment's pension costs that were reimbursed by HCFA to BCBSCo and BCBSNM for prior years are covered by "Closing Agreements" executed by HCFA. By their own terms and as required by the standard Medicare contracts, each of these "Closing Agreements" constitutes a "final determination" of the amount of allowable costs chargeable to Medicare for the period covered by the Agreement. *See, e.g.*, Agreement No. HCFA 87-001-1.6, Art. XVI, ¶ K. Costs covered by such a "Closing Agreement" are therefore not subject to subsequent adjustment by the government. *See, e.g., Continental Aviation & Engineering Corp.*, ASBCA Nos. 9894 & 9938, 65-1 BCA ¶ 4660 at 22,289-90; *see also Blue Cross & Blue Shield Ass'n v. United States*, 13 Cl. Ct. 710, 715 (1987), *aff'd without op.*, 852 F.2d 1294 (Fed. Cir.), *cert. denied*, 488 U.S. 993 (1988); *Blue Cross Ass'n & Blue Cross of Virginia*, ASBCA No. 25776, 81-2 BCA ¶ 15,359 at 76,079, 76,083-84. Indeed, HCFA's practice of excluding pension costs incurred after fiscal year 1987 from the finality of its Medicare "Closing Agreements" confirms that pension costs are among the costs normally covered by such agreements; if pension costs were not covered by "Closing Agreements," there would have been no need to explicitly exclude them from the operation of such agreements.

Accordingly, the only pension costs that may be adjusted pursuant to CAS 413.50(c)(12) are those reimbursed pension costs of the Medicare segment that are not covered by a "Closing Agreement" executed by HCFA, and the amount of any such adjustment is limited to the total

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2/ The revisions to CAS 412, CAS 413 and, in particular, to CAS 413.50(c)(12), that were promulgated on March 30, 1995, are inapplicable here. Under its effective date provision, that revision applies only to contractors who received a new contract after March 30, 1995. Neither BCBSCo nor BCBSNM received a new Medicare contract after that date. Accordingly, all references in this letter to CAS 412 and 413 are to the pre-revision versions of those standards.

Medicare segment pension cost reimbursement for periods in which pension costs are not covered by a "Closing Agreement." Here, we understand that the total amount of reimbursed pension costs not covered by a "Closing Agreement" for both the Medicare and non-Medicare segments is approximately $784 thousand. Since this amount includes reimbursed pension costs relating to the non-Medicare segment, the maximum adjustment to which the government could be entitled is less than this amount.[3/]

B. Any Pension Cost Adjustment Under CAS 413.50(c)(12) May Not Exceed The Medicare Segment's Pension Costs That Were Actually Reimbursed By HCFA After CAS 413 First Became Applicable To The Medicare Contracts.

Any adjustment of the previously determined pension costs of BCBSCo and BCBSNM under CAS 413.50(c)(12) may not exceed the amount of the Medicare segment's pension costs that were reimbursed by HCFA after fiscal year 1980, even assuming that no "Closing Agreement" limits the amount of that adjustment. This is so because CAS 413, the only procurement regulation purporting to provide for a "segment closing" adjustment, did not become applicable to the Medicare contracts of BCBSCo and BCBSNM until the fiscal year beginning October 1, 1980. CAS 413.50(c)(12) cannot provide the basis for adjusting costs that were incurred on prior Medicare contracts because CAS 413 never applied to those costs or contracts; only pension costs incurred after CAS 413 became applicable to Medicare are subject to adjustment.

It is a basic axiom of government procurement law that only those procurement regulations that are incorporated in a contract on its effective date may be applied to the contract. Subsequently promulgated or revised regulations cannot be applied to contracts already in existence on the date of the promulgation or revision. This axiom is well established in the case law. For example, a number of cases have considered the impact of a change in the cost principles -- the regulations governing the costs that can be reimbursed under government contracts -- under two contracts, one of which was entered into prior to the effective date of the change and the other of which was entered into after that effective date. These cases have consistently held that the cost principle change may be applied to the contract entered into after the effective date of the change but may not be applied to the contract entered into prior to that effective date. *See, e.g., Dynalectron Corp.*, ASBCA No. 20240, 77-2 BCA ¶ 12,835; *The Boeing Co.*, ASBCA No. 11866, 69-2 BCA ¶ 7898, *aff'd on reconsid.*, 70-1 BCA ¶ 8298, *aff'd*, 480 F.2d 854, 863 (Ct. Cl. 1973). Other

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3/ Similarly, HCFA is not entitled to any remittance for an "adjustment" of the pension costs charged to BCBSCo's fixed-price Medicare contract for fiscal years 1983 through 1986 because the price of a fixed-price contract, by definition, may not be affected by an "adjustment" of costs.

cases have refused to apply a new or revised cost principle to contracts that were entered into prior to the effective date of the new or revised cost principles. *See, e.g., Lockheed Aircraft Co. v. United States*, 426 F.2d 322, 327-28 (Ct. Cl. 1970); *Lockheed-Georgia Co., A Division of Lockheed Corp.*, ASBCA No. 27760, 90-3 BCA ¶ 22,957.

Thus, only the pension costs of the Medicare segment that were actually reimbursed by HCFA for the fiscal years after CAS 413 first became applicable to the Medicare contracts of BCBSCo and BCBSNM may be adjusted under the authority of CAS 413.50(c)(12), and any such adjustment may not exceed the amount of the Medicare segment's pension costs that were reimbursed by HCFA for periods after that date. Although we have not precisely determined the amount of these costs, we are certain that significantly fewer than $4 million of Medicare segment pension costs were charged to Medicare by BCBSCo and BCBSNM during fiscal year 1981 and subsequent fiscal years.

II. THE REPORT MISSTATES THE AMOUNT OF THE PENSION ASSETS ATTRIBUTABLE TO THE MEDICARE SEGMENT.

Upon the closure of a segment, CAS 413.50(c)(12) provides for an "adjustment of previously-determined pension costs," measured by the "difference between the market value of assets and the actuarial liability for the segment." Here, the draft audit report overstates the amount of any such adjustment by misstating the amount of pension assets attributable to the Medicare segment at the time it purportedly closed.

It does so by: (1) assigning contributions to the Medicare segment when no pension costs were actually reimbursed by HCFA; (2) transferring to the non-Medicare segment the pension assets attributable to Medicare segment retirees and vested terminated employees; (3) transferring to the non-Medicare segment the pension assets attributable to those employees who were active Medicare segment employees as of the effective date of the segment closing adjustment calculation; (4) failing to transfer a proportionate share of any pension overfunding when active Medicare employees transferred to non-Medicare lines of business; and (5) failing to allocate pension expenses and earnings to reflect the proper asset levels.

A. The Report Improperly Allocates Pension Contributions To The Medicare Segment.

The draft audit report allocates the pension contributions made by BCBSCo and BCBSNM to the Medicare and non-Medicare segments in proportion to their relative normal costs plus accrued liabilities. The use of this allocation method resulted in an overstatement of the pension assets attributable to the Medicare segment. For example, the report assigns $90,043 of pension contributions to the BCBSCo Medicare segment for 1986; however, we understand that HCFA

did not reimburse BCBSCo for any pension expense in that year. Under CAS 413.50(c)(5) & (7), a contractor is required to track the "amount of funds contributed by, or on behalf of, the segment." Under these provisions, HCFA is entitled to be credited with a contribution only when it actually funds the contribution. The asset values in the draft audit report should be adjusted to ensure that HCFA receives credit for a contribution only in those years in which it makes a contribution, and then only in the amount of the reimbursed pension expense that relates to the Medicare segment.

B. The Report Should Not Transfer Any Of The Pension Assets Attributable To Inactive Medicare Employees.

In determining the amount of assets attributable to the Medicare segment, the draft audit report transfers to the non-Medicare segment upon the retirement or termination of a vested Medicare employee a share of the pension assets attributable to that employee as well as that employee's entire actuarial liability. However, CAS 413 contemplates the transfer of the pension assets and liabilities attributable to employees upon their retirement or termination only where the contractor maintains a separate segment devoted exclusively to a contractor's inactive pension plan participants. For example, CAS 413.50(c)(9) provides in part:

> Contractors who separately calculate the pension cost of one or more segments may calculate such cost either for all pension plan participants assignable to the segment(s) or for only the active participants of the segment(s). If costs are calculated only for active participants, a separate segment shall be created for all of the inactive participants of the pension plan and the cost thereof shall be calculated.

Because neither RMHCC, BCBSCo, nor BCBSNM maintained a separate segment devoted exclusively to inactive plan participants, we believe that no transfers of the pension assets or liabilities attributable to such participants should have been made. The Medicare segment's assets should be recalculated without such transfers.[4/]

4/ Even assuming that an asset transfer is appropriate upon retirement or termination, the auditors failed to transfer the proper amount of assets. CAS 413.50(c)(9) requires that the amount of transferred assets shall be proportional to that portion of the individual's actuarial liabilities that have been funded. Thus, if liabilities are 80% funded, assets equal to 80% of the liabilities should be transferred. Similarly, if liabilities are 120% funded, assets equal to 120% of the liabilities should be transferred. However, where liabilities were funded at a 120% level, for

(Footnote continued on next page)

C. The Report Should Not Transfer All Of The Active Employees From The Medicare Segment Prior To Calculating The Segment Closing Adjustment.

The report calculates the segment closing adjustment as of January 1, 1996, a date *after* the cessation of all Medicare activity at BCBSCo and BCBSNM. The use of this date had a significant influence on the auditors' calculation: "Due to the termination of the Medicare contracts, we transferred all plan participants out of the Medicare segment as of December 31, 1995." Thus, prior to calculating the amount of the segment closing adjustment, the report transfers to the non-Medicare segment all of the actuarial liabilities of the employees who had been active in the Medicare segment during the period just prior to the cessation of Medicare activities, and had also transferred a share of the pension assets attributable to those employees. This transfer was inappropriate. Such employees should have been treated as part of the Medicare segment for purposes of calculating any segment closing adjustment.

The draft audit report explains the selection of January 1, 1996, as the segment closing date in part by suggesting that RMHCC had agreed "that January 1, 1996 would be an appropriate date for the closing of the segment." RMHCC actually agreed to something quite different: "We have no objection to basing the audit on the January 1, 1996 valuation data, but we reserve the right to challenge at a later date if it does not appear to be appropriate." As explained below, RMHCC does not now believe that it is appropriate to calculate the segment closing adjustment as of January 1, 1996, although it may be appropriate to use certain data from the January 1, 1996, valuation if the use of that data would not have inequitable consequences.

CAS 413.50(c)(12) provides guidance as to the effective date of the segment closing adjustment calculation. Contrary to the report's implication, that date is not the date that the segment actually closes, but rather is the date of the event that causes the segment to close or some other equitable date. CAS 413.50(c)(12) provides in part:

> The calculation of the difference between the market value of the assets and the actuarial liability shall be made as of the date of the event (e.g., contract termination) that caused the closing of the segment. If such a date cannot be readily determined, or its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date.

(Footnote continued from previous page)
example, your auditors transferred assets equal to 100% of the liabilities, retaining the surplus assets in the Medicare segment.

Here, the use of January 1, 1996 -- a date after the segment actually ceased operations -- as the effective date of their segment closing adjustment calculation resulted in their being *no* actuarial liabilities in the segment. It is difficult to reconcile this result with the structure of CAS 413.50(c)(12), which contemplates a comparison of the assets *and actuarial liabilities* of the segment. If the CAS Board had intended that all segment participants would be transferred out of the segment prior to the effective date of the segment closing adjustment calculation, it would have provided that the adjustment would be determined by the amount of the pension assets remaining in the segment. Moreover, we do not believe that the use of January 1, 1996, as the effective date of the segment closing calculation resulted in an "equitable calculation."

Accordingly, the segment closing adjustment should be recalculated using a date that is both in compliance with CAS 413.50(c)(12) and more equitable. Although we have not yet fully considered the question, we believe that it may be appropriate to calculate the segment closing adjustment as of the date of the contractual notice that BCBSNM would no longer be a Medicare contractor; this date can fairly be characterized as the date of the event that caused the segment closing. The use of such a date would ensure that active Medicare employees would be part of the segment as of the effective date of the segment closing calculation.

D. For Those Active Employees For Whom Asset Transfers Were Appropriate, The Report Should Also Transfer The Surplus Associated With Such Employees.

When an active employee transferred between the Medicare segment and the non-Medicare segment, the draft audit report transfers the employee's entire actuarial liability to the transferee segment, and transfers assets in proportion to the actuarial liability of the transferred active participants, but no more than 100% of such liability. Under this asset transfer method, any excess pension assets associated with the transferred employees are retained by the transferor segment. However, the report should first consider whether any transfer was required by CAS 413.50(c)(8) and, if so, then transfer all of the assets, including any surplus, associated with the transferred active participants.

The only CAS provision concerning asset transfers relating to active participants is CAS 413.50(c)(8). It provides:

> If plan participants transfer among segments, contractors need not transfer assets or liabilities unless a transfer is sufficiently large to distort the segments' ratio of fund assets to actuarial liabilities.

Although this provision does not expressly specify the amount of assets to be transferred, the CAS Board's intent is clear: the transferor segment's ratio of pension assets to liabilities should

not be distorted as a result of the transfer of employees from one segment to another. Therefore, it intended that: (1) assets and liabilities must be transferred only where the transfer of employees is sufficiently large to distort the ratio of assets to liabilities; and (2) the transfer of assets and liabilities must be such that the transferor segment's ratio of assets to liabilities is not distorted.

The draft audit report runs afoul of each of these requirements. First, the report apparently transfers assets and liabilities without any prior determination as to whether a distortion would result absent such a transfer. Second, the only way in which a transfer of assets and liabilities would not affect the transferor segment's ratio of assets to liabilities would be if the assets and liabilities were transferred in the same ratio as in the transferor segment. The report apparently complies with this logic when a transferred employee's liabilities were underfunded, but not when the liabilities were overfunded.

We request that the amount of the assets attributable to the Medicare segment be recalculated by transferring assets only when an employee's transfer would materially distort the ratio of assets to liabilities of the transferor segment, and by transferring an amount of assets proportionate to the funded ratio of that segment. For example, if there was a material transfer of employees from the Medicare segment to the non-Medicare segment and the Medicare segment's liabilities were at that time 120% funded, assets equal to 120% of the transferred employees' actuarial liabilities should be transferred from the Medicare segment to the non-Medicare segment.

E. The Expenses And Earnings Attributed To The Medicare Segment Should Be Adjusted To Account For The Asset Adjustments Outlined Above.

CAS 413.50(c)(7) provides that "[f]und income and expenses shall be allocated to the segment in the same proportion that the assets allocated to the segment bears to total fund assets as of the beginning of the period for which the fund income and expenses are being allocated." The adjustments discussed above in Part II, Sections A through D, will result in changes to the assets that are attributed to the Medicare segment. In compliance with CAS 413.50(c)(7), the amount of expenses and earnings attributed to the Medicare segment should be adjusted to reflect the asset adjustments discussed above.

III. THE REPORT MISSTATES THE AMOUNT OF THE ACTUARIAL LIABILITIES ATTRIBUTABLE TO THE MEDICARE SEGMENT.

Upon the closure of a segment, CAS 413.50(c)(12) provides for an "adjustment of previously-determined pension costs," measured by the "difference between the market value of assets and the actuarial liability for the segment." Because of the transfers of the liabilities of inactive Medicare segment participants and of the liabilities of the Medicare employees who were active

as of the effective date of the segment closing calculation, which are discussed above, the report determines that there were no Medicare segment actuarial liabilities at segment closing for purposes of determining "the adjustment of previously-determined pension costs."

As a result of the "transfer" adjustments discussed above in Part II, however, there will remain in the Medicare segment at segment closing a significant amount of actuarial liabilities pertaining to the following pension plan participants: (1) retired or vested terminated Medicare employees; and (2) Medicare employees who are active as of the effective date of the segment closing adjustment calculation. The difference between these liabilities, properly valued, and the market value of the segment's pension assets represents the "adjustment of previously-determined pension costs" contemplated by CAS 413.50(c)(12).

The segment closing calculation should be adjusted to reflect properly the actuarial liabilities of the Medicare segment. The amount of those actuarial liabilities should be determined as follows: (1) a projected benefit measure of liability should be used for those employees who were active Medicare employees as of the effective date of the segment closing adjustment calculation; (2) all of the actuarial liabilities should be valued using the discount rate promulgated by the Pension Benefit Guaranty Corporation ("PBGC") for the month during which the segment closed; and (3) the actuarial liability for the Medicare segment should reflect the present value of future administrative expenses.

A. A Projected Benefit Measure Of Liability Should Be Used For Those Active Medicare Employees Who Transferred To The Non-Medicare Segment Following The Termination Of The Medicare Segment.

Consistent with the requirements of CAS 412.50(b)(1) & (2), RMHCC, BCBSCo, and BCBSNM utilized a projected benefit cost method to determine its annual pension costs. Under that method, the pension cost attributable to the current year properly reflects the actuarial assumption that certain of the contractor's employees will receive salary increases in future years. In contrast, the accrued benefit cost method is based solely on the pension benefits accrued to date by a pension plan participant, and does not consider the assumed escalation in salaries that was integral to the contractors' CAS 412-compliant pension cost method.

For those employees who were active Medicare employees as of the effective date of the segment closing adjustment calculation, the projected benefit cost method is the only appropriate method of valuing actuarial liability for purposes of CAS 413.50(c)(12). Those employees remained with the contractors and received or will receive salary increases. Under the contractors' CAS 412-compliant pension cost method, the pension cost associated with those salary increases was properly reflected in the pension costs incurred prior to the termination of the Medicare contracts. In contrast, the use of an accrued benefit cost method would understate the actuarial

liabilities associated with employees who remain with the contractors because it would omit from the calculation of the Medicare segment's actuarial liability a portion of the actuarial liability generated in prior years by an employee's Medicare service.

In fact, CAS 413's segment closing provision requires the use of a projected benefit cost method in valuing a segment's actuarial liabilities where, as here, the contractors used that method for purposes of determining pension costs under CAS 412. That is so because the segment closing adjustment under CAS 413.50(c)(12) is calculated as the "difference between the market value of assets and the *actuarial liability* for the segment," and "actuarial liability" is defined by CAS 413.50(a)(4) in part as the "pension cost attributable, *under the actuarial method in use*, to years prior to the date of a particular actuarial valuation." (Emphases added). The projected benefit method must be used to value the actuarial liabilities of those employees who were active Medicare employees as of the effective date of the segment closing adjustment calculation because that was the "actuarial method in use."

B. The Actuarial Liabilities Should Be Valued Using The Discount Rate Promulgated By The PBGC.

The actuarial liabilities of the Medicare segment should be valued using the discount rate promulgated by the PBGC for use in valuing the liabilities of pension plans that terminated during the month for which the segment closing calculation is being made. This is so for two reasons: (1) CAS 413 requires, and its drafters intended, that the PBGC discount rate be used to value the actuarial liabilities of a closed segment; and (2) the discount rate used to value the actuarial liability must reflect current market conditions at the time of the segment closing event in order to be consistent with the requirement of CAS 413.50(c)(12) that the segment's assets be valued at market.

First, CAS 413.50(c)(12) specifically contemplated that the interest rate promulgated by the PBGC would be used for purposes of the "adjustment of previously-determined pension costs" by providing that "[t]he determination of the actuarial liability shall give consideration to any requirements imposed by agencies of the United States Government." Preamble A to CAS 413, issued in 1977 upon the initial promulgation of CAS 413, explains this provision:

> The Board recognizes that, in some cases, the closing of a segment could be associated with a termination of a plan. Several commentators noted that, in such a case, the actuarial liability for that segment could be greatly influenced by regulations developed pursuant to the provision of ERISA. The standard specifically permits the effect of such regulations to be considered in determining the actuarial liability for the segment.

> It should be noted that the provisions of this section are appropriate whenever a segment performing a material amount of Government business is closed, irrespective of whether the closing is caused by the completion of a contract or an organizational change, or whether the closing results in a complete or partial termination of the plan.

The PBGC promulgates an interest rate required to be utilized in determining the actuarial liability of a terminating pension plan at plan termination. Thus, the CAS provision providing that "[t]he determination of the actuarial liability shall give consideration to any requirements imposed by agencies of the United States Government," contemplated the use of the PBGC rate because the use of that rate is required by an agency of the United States government.

Second, CAS 413.50(c)(12) requires a comparison between the value of a closed segment's pension assets and the value of its actuarial liabilities. For this calculation, CAS 413.50(c)(12) specifically requires that the closed segment's pension assets be valued at market as of the date of segment closure. Consistency requires that the closed segment's actuarial liabilities also be valued using an interest rate, such as the PBGC rate, that is consistent with market conditions at the time of segment closure. A valuation of the Medicare segment's pension assets in a manner that reflects the interest rate environment prevailing at the time the segment closed, while valuing its actuarial liabilities using the pension plan's higher interest rate assumption, would result in a meaningless comparison of "apples and oranges." As explained below, such a comparison would understate the Medicare segment's actuarial liabilities relative to the value of its pension assets and would overstate the amount of any remittance owed the government under CAS 413.50(c)(12).

For ongoing pension funding purposes, RMHCC, BCBSCo, and BCBSNM valued their pension assets and liabilities using actuarial methods that smoothed the effects of short-term fluctuations in market value and market interest rates. For example, in accordance with CAS 412.50(b)(5) and CAS 413.40(b), they determined the value of pension assets using an actuarial method that smoothed fluctuations in market value and yielded actuarial values that differed significantly from market values. The market values of many pension assets, such as corporate bonds, are sensitive to interest rate fluctuations. The market values of such assets will generally be higher than their actuarial values when the market interest rate is lower than the actuarially smoothed interest rate assumption. At the time of the segment closure, the prevailing interest rates were lower than the actuarially smoothed interest rate used by the pension plans.

Similarly, in accordance with CAS 412.50(b)(5), the contractors utilized a discount rate for valuing actuarial liabilities that smoothed the effect that short-term fluctuations in interest rates have on those actuarial liabilities. A reduction in the discount rate used to calculate the present

value of an actuarial liability will increase that present value, while an increase in the discount rate will reduce it. Thus, the present value of the actuarial liability calculated using the actuarially smoothed interest rate would have been significantly less than the present value calculated using the lower market interest rate that was prevailing at the time the segment purportedly closed.

CAS 413.50(c)(12) does not, however, permit the use of an actuarially smoothed asset value in calculating the adjustment of previously determined pension costs. Instead, it specifically requires that "the market value of assets allocated to the segment" be determined "as of the date of the event . . . that caused the closing of the segment." The difference between actuarial asset value and market asset value in part reflects that interest rate environment prevailing on the date of the market valuation. For example, a corporate bond held by a pension plan that was issued with a yield of 8.50% will increase in market value if the market interest rate decreases to 7.25%, but that increase in market value will not be fully reflected by a valuation method that "smoothes" short-term fluctuations in asset value. In contrast, the fair market value of pension assets on a particular day fully reflects the interest rate and yield expectations of the marketplace on that date.

In order for a CAS 413.50(c)(12) calculation to be meaningful, the measure of a closed segment's actuarial liability should also reflect the interest rate and yield expectations of the marketplace on the date of the event that caused the segment closing. If not, the actuarial liability will be valued in a manner that is inconsistent with the required fair-market valuation of the closed segment's pension assets.

That inconsistency would significantly distort the calculation of the adjustment of previously determined pension costs for the Medicare segment. Valuing the actuarial liabilities using the pension plan's interest rate assumption, while valuing the pension assets in a manner that reflects the lower interest rates prevailing upon closure of the Medicare segment, would result in an understatement of the segment's actuarial liabilities relative to the value of its pension assets. Valuing its pension assets at market would increase the value of those assets, relative to their actuarial value, because that market value reflects the increase in value caused by a reduced interest rate environment. In contrast, valuing the segment's actuarial liabilities using the pension plan's ongoing interest rate would not fully recognize the increase in the present value of the actuarial liabilities that result from a reduced interest rate environment. Thus, the use of the plan's ongoing interest rate to value the Medicare segment's actuarial liabilities for purposes of the CAS 413.50(c)(12) adjustment would result in an overstatement of the recommended amount of any "adjustment of previously-determined pension costs" that may be due the government as a result of any closure of the Medicare segment.

C. The Calculation Of The Actuarial Liability Of The Medicare Segment Should Consider The Present Value Of Future Administrative Expenses.

The actuarial liability of the Medicare segment should also consider the present value of the future pension plan administrative expenses relating to the employees in the Medicare segment. That is so because the segment closing adjustment under CAS 413.50(c)(12) is calculated as the "difference between the market value of assets and the *actuarial liability* for the segment," and "actuarial liability" is defined by CAS 413.50(a)(4) in part as the "excess of the *present value of the future benefits and administrative expenses* over the present value of future contributions for the normal cost for all plan participants and beneficiaries." (Emphases added).

* * *

Thank you again for affording RMHCC this opportunity to comment on draft Audit Report No. CIN: A-07-97-01234. We believe that the resolution of the issues raised by that report can best be achieved through an open dialogue between the government and the contractors. To that end and because many of the issues raised are technical and complex, we would be pleased to discuss the draft audit report, our comments, and our suggested recalculation with you or your staff prior to the issuance of your final report.

Sincerely,

William P. Crossen
Vice President, Financial Services

cc: Thomas J. Gillgannon, Director Government Operations, BCBSCO
Kurt B. Shipley, Vice President & Chief Financial Officer, BCBSNM

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MEMORANDUM

February 13, 1998

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

From: Eric H. Shipley
Office of the Actuary

Subject: Rocky Mountain Health Care Corp. Response to Draft Audit Reports on Pension Costs Charged to the Medicare Program and the Segment Closing Adjustment under CAS 413-50(c)(12)

In a letter dated September 10, 1997, Rocky Mountain Health Care Corp.(Rocky Mountain) has objected to the dollar finding in the audit report on the closing of their Medicare Segment, CIN A-07-97-01234. Their letter raises ten (10) specific objections to the segment closing finding which are summarized below in the order in which they were presented:

1. The pension cost adjustment is constrained to only pension costs reimbursed during periods not covered by closing agreements.

2. The pension cost adjustment is constrained to only pension costs reimbursed since CAS 413 first became applicable to the Medicare contracts.

3. Pension contributions were improperly allocated to the Medicare Segment.

4. Pension assets attributable to the inactive Medicare employees should not have been transferred.

5. There should not have been a transfer all of the active employees from the Medicare Segment prior to calculating the segment closing adjustment.

6. Where asset transfers were appropriate for active employees, any transfer should include a portion of the surplus assets.

7. Expenses and earnings allocated to the Medicare Segment should be adjusted to account for the asset adjustments outlined above.

8. A projected benefit measure of liability should be used for those active Medicare employees who transferred to the non-Medicare segment following the termination of the Medicare Segment.

9. The actuarial liabilities should be valued using the discount rate promulgated by the PBGC.

10. The calculation of the actuarial liabilities of the Medicare Segment should consider the present value of administrative expenses.

My analysis is based upon both Cost Accounting Standards (CAS) 412 and 413 that were in effect at the time of Rocky Mountain's segment closing.[1] Because of the multitude and complexity of pension issues, the Cost Accounting Standards Board (CASB) developed the accounting standards for pension cost in two stages. The CASB first addressed basic measurement and period assignment issues in CAS 412. In CAS 413, the CASB addressed how pension costs, which were measured under CAS 412, were to be adjusted for gains and losses and were to be allocated to segments. Consequently, these two standards must be taken together for any analysis to properly reflect the intent of the original Board. Moreover, when the current CAS Board amended CAS 412 and 413, the two standards were consistently treated as a unit in the Staff Discussion Paper, the Advance Notice of Proposed Rule Making, the Notice of Proposed Rule Making, and the Final Rule.

My analysis is also based upon the actuarial valuations, Internal Revenue Service filings, responses to the pension segmentation questionnaire, and the proposed accounting of assets prepared by Rocky Mountain and its actuary, Watson Wyatt Worldwide. These documents and information were presented by Rocky Mountain to substantiate its claim for pension costs under the Medicare contracts as well as the basis for the required CAS 413-50(c)(12) adjustment. Much of Rocky Mountain's letter dated September 10, 1997 appears to ignore the information and accounting practices that Rocky Mountain has presented and consistently used in the past. Although Rocky Mountain seems to imply that the auditors created or used practices, data, and information of their own, the fact remains that the auditors reviewed and reported upon the material prepared and presented by Rocky Mountain. Rocky Mountain takes exception to many of the practices and methods which its actuary has employed and which Rocky Mountain has accepted each year.

1. The pension cost adjustment is constrained to only pension costs reimbursed during periods not covered by closing agreements.

I disagree.

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[1] This memorandum addresses the provisions of CAS 412 and 413 that were in effect prior to the amendments that were published on March 30, 1995.

a) The FAR 31.201-5 "Credits Clause" gives the Government entitlement to its share of the adjustment computed under CAS 413-50(c)(12).

When Rocky Mountain's segment closed, the so-called "credits clause" found at FAR 31.201-5 provides the Government with a contractual entitlement to its share of the adjustment measured and assigned to a period in accordance with CAS 413-50(c)(12). In the recent Gould, Inc. decision, ASBCA No. 46759, dated September 19, 1997, both parties were in agreement that the Government was entitled to a share of the segment closing adjustment through the credits clause applicable to Gould's cost-type contracts.[2] The judge's decision clearly agreed with the entitlement under the cost-type contracts. More importantly, the judge did not limit the amount of the Government's claim. In fact, the judge was persuaded by the testimony of Gould's expert witness that the segment closing "adjustment of "previously-determined pension costs" should be reflected on the appellant's books and records as an adjustment to pension cost in the period of the segment closing." The judge further noted that "the amount of overfunding would end up being a credit to the cost accounts."

Part of the testimony by Gould's expert witness, who was a member of the original CASB's Staff, noted the analogous treatment of gains and losses upon the sale of a depreciable asset under CAS 409-50(j)(1) and (3). Pension costs, like annual depreciation, are dependent upon estimated future values. When a future event, a segment closing or sale of an asset, changes that future estimate, then the CAS provides for an immediate period adjustment to compensate for the over- or under-statement of the expected value during prior periods.

b) Current period pension costs are based on liabilities incurred in the current period, prior periods, and expected to be incurred in future periods.

Unlike other categories of cost, pension cost determinations are not limited to the liability or expense incurred in a single period. CAS 412-40(a)(1) states that there are four components of pension costs; namely, normal cost, a part of any unfunded actuarial liability, an interest equivalent on the unamortized portion of any unfunded actuarial liability, and an adjustment for any actuarial gains and losses. The computation of the normal cost and the actuarial liability for an ongoing segment covered by an ongoing pension plan includes recognition of service and earnings levels that are estimated to be earned in future years. In the case of a 25 year old plan participant, this estimate may include projections for the next 40 years. The amortization installments, including an adjustment for interest, on the unfunded actuarial liability is a current

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[2] At the time of the segment closing, Rocky Mountain's Medicare contracts were cost-type contracts subject to the FAR credits clause. The segment closing adjustment amount is based upon the initial allocation of assets in 1986 and the subsequent separate accounting of segment assets Rocky Mountains' cost-type Medicare contracts. This contractually agreed-upon initial allocation of assets represents the accumulated value of prior pension costs allocable to all lines of business, including any commercial work or fixed price contracts.

period charge for benefit liabilities earned by participants during prior periods. Since CAS 412 permits amortization of some portions of unfunded actuarial liability to be spread over 30 years, some of these current period charges can be attributable to benefit liabilities incurred 30 years ago. Likewise, the amortization installment for gains and losses can include current charges or credits for events that occurred up to 15 years prior.

When developing and promulgating CAS 412, the original Cost Accounting Standards Board (CASB) and its staff considered restricting the pension cost for Government contracts to the recognition of only benefits earned in the current period. Because the actuarial liability is attributable to liability incurred for service rendered during prior periods, the actuarial liability, also known as the past service liability, was viewed as being an out of period cost. The accounting and actuarial communities persuaded the CASB that accepted accounting and actuarial practice spread the unfunded actuarial liability over many years. Thus, the CASB explicitly provided for the amortization of all portions of unfunded actuarial liability and thereby permitted that a portion of liability earned and incurred in prior periods to be recognized and charged to contract costs in the current period.

Similarly, the original CASB and staff considered restricting the recognition of pension costs so that only the current level of benefits earned would be recognized. Again the accounting and actuarial professions convinced the CASB that accepted practices permitted recognizing projected salary levels and future service in the computation of pension cost. Additionally, the original CASB became aware that inter-period costs would be more stable, and therefore forward pricing would likewise be more stable, if period costing was based on reasonable future expectations.

If Rocky Mountain's assertion was correct that the CASB limited pension costs to only current period considerations, then the CASB would have limited the measurement of pension costs to the normal cost and would not have permitted the recognition of future salary levels and service.

c) The original CASB intended and explicitly provided for CAS 413-50(c)(12) to measure an adjustment of prior period costs in a current period if a segment closed.

After CAS 412 was issued, the CASB and its staff began to look at the issues of "abnormal forfeitures" and experience gains and losses. The abnormal forfeiture issue developed into two concerns. The first concern dealt with isolating material employment gains or losses to the segment wherein the loss occurred. The second concern was with the large gain that can occur when a plant or operational unit would close, often because of a loss of Government contract work. The first concern regarding abnormal forfeitures was addressed by the requirement for separate computation of segment costs if employee turnover differs significantly between segments. The second concern lead the Board to consider the general effects of a loss of Government contract work. The Board realized that the normal accounting for pension costs on

an ongoing basis spread the costs of a single period event; such as establishment of a pension plan, plan amendment, plant closing, and experience gain or loss, over future cost accounting periods. However, when a segment closes there may not be any future contract periods during which the delayed portion of current and prior period liabilities and gains could be charged or credited to a Government contract(s).

Therefore, the CASB provided that a special current period adjustment be measured whenever a segment closed. The CASB knew that some portions of prior period liabilities and prior period gains and losses had been delayed and thus unrecognized. More importantly, there often could be substantial actuarial gains when an organizational unit ceased to exist. That gain would not be properly credited to Government contracts under the normal delayed recognition if there were no future contracts. If the contractor had been able to foresee the substantial gain, prior period costs allocated to contracts would have been lower.[3] Because prior period costs were based on estimates about future events, some of which will have come to pass by the current period, the pension costs of prior periods were either too high or too low because the estimates deviated from actual results. The CASB decided that in such cases a current period adjustment, representing the over- or under-estimation of prior period costs, was necessary. Such an adjustment of prior period costs was explicitly provided for at CAS 413-50(c)(12).

d) CAS 413-50(c)(12) Adjustment includes interest earned on Government's share of contributions held in trust fund.

It is well established that when funds are invested, the Government shares in the earnings, investment expenses, and the appreciation or depreciation attributable to those funds.[4] This principal was directly reflected in CAS 413-50(c)(7) which states:

> "After the initial allocation of assets, the contractor shall maintain a record of the portion of subsequent contributions, income, benefit payments, and expenses attributable to the segment and paid from the pension fund. Income and expenses shall include a portion of any investment gains and losses attributable to the assets of the pension fund. Fund income and expenses shall be allocated to the segment in the same proportion that the assets allocated to the segment bears to the total fund assets as of the beginning of the period for which fund income and expenses are being allocated."

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[3] When a contractor inquired what was the proper accounting when the contract knew in advance that it would lay-off employees at the end of a contract, Bernie Sachs, a member of the original CASB Staff, advised the contractor to compute lower pension costs by anticipating the termination of employment gain from the expected lay-off.

[4] Refer to ITT Federal Support Services, Inc v. the United States, No. 138-73, United States Court of Claims, March 17, 1976.

The segment closing adjustment is not limited to the Government's share of contributions, but to the Government's share of any pension fund assets not required to provide for the actuarial liability earned by the Medicare segment's plan participants while rendering service under Medicare contracts.

2. The pension cost adjustment is constrained to only pension costs reimbursed since CAS 413 first became applicable to the Medicare contracts.

I disagree.

See the discussion under topic # 1.

As noted above, the accounting and actuarial communities persuaded the CASB that actual practice contemporaneous to the early 1970's included cost elements attributable to liabilities incurred in prior periods. CAS 412 was designed to permit for most companies to generally continue their existing practices and methods for determining pension cost. Because of this, there was little change in the practices and methods employed in the determination of Government contract costs before and after CAS 412 and 413 became applicable. The original CASB, could have, but did not limit, the measurement of any CAS 413-50(c)(12) adjustment to only periods after CAS 413 was applicable.

There is no evidence that Rocky Mountain changed its actuarial methods and techniques used for contract cost purposes when it became subject to CAS 412 and 413 in 1981. Prior to 1981, Rocky Mountain's cost accounting practices for pension costs had to be acceptable under Accounting Principle Board's Opinion Number 8 in order to be allowable under the Federal Procurement Regulation. As noted above, the FAR and the CAS permitted the contractor to continue the same practices regarding pension costs after 1981.

Nor is the CAS 413-50(c)(12) segment closing adjustment a new requirement. The Cost Principals subcommittee responsible for the promulgation of the FAR viewed the CAS 413 segment closing provision as an evolution of the FPR's provision for an immediate period adjustment for an "abnormal forfeiture". Therefore the CAS 413-50(c)(12) can not be viewed or characterized as giving the Government new rights to an adjustment when an operational unit closes.

3. Pension contributions were improperly allocated to the Medicare Segment.

I disagree.

Prior to 1986, Rocky Mountain was not separately determining the pension for its Medicare Segment. Instead, as required by the contract clause on pension segmentation, Rocky Mountain was to determine a pension cost for the entire pension plan and then to allocate a

portion of the funded pension cost to the segment on the same basis used to allocate pension costs to all final cost objectives, including fixed-price contracts. Typically for a Blue Cross Blue Shield Plan this is done by allocating pension cost to cost centers and then to lines of business.

In its response to the pension cost questionnaire, Rocky Mountain stated that it had allocated $94,370 to the Medicare segment for 1986. After considering any audit adjustments recommended for the cost centers and plan participants identified with the Medicare segment, the auditors emulated Rocky Mountain's allocation practice and allocated $90,043 to the segment.

In allocating the pension cost to the segment, the auditors used the same method employed by Rocky Mountain and its actuary. This method directly assigns normal costs to cost centers by active participant and allocates the net amortization installment to cost centers based on the actuarial liabilities of each cost center's participants. Because the allocation method used by Rocky Mountain, and by most other members of the National Employees Benefit Association's (NEBA's) pension program, considers bases that are representative of the factors on which the pension cost was determined, the auditors and HCFA view such allocations as conforming to CAS 413-50(c)(1) which states:

> "For contractors who compute a composite pension cost covering plan participants in two or more segments, the base to be used for allocating such costs shall be representative of the factors which the pension benefits are based. For example, a base consisting of salaries and wages shall be used for pension costs that are calculated as a percentage of salaries and wages; a base consisting of the number of employees shall be used for pension costs that are calculated as an amount per employee."

4. Pension assets attributable to the inactive Medicare employees should not have been transferred.

I disagree.

Rocky Mountain, like most other NEBA members, has had Watson Wyatt Worldwide, their actuary, develop the "asset fraction" considering only active members of the Medicare segment. To simplify the work associated with establishing the initial segment, determining the asset fraction and initial asset allocation, and determining the annual pension cost, the Wyatt Company identifies three segments as of 1986; one for active employees in the Medicare segment, one for active employees in all other operational segments, and an inactive segment. Since 1988, Wyatt has consistently determined pension costs separately for the Medicare segment and for an aggregation of all other segments, including the inactive segment. Medicare segment pension costs are then allocated to costs centers within the Medicare segment and then to lines of business. Likewise, pension costs for the aggregation of "other" segments are then allocated to costs centers within the "other" segment and then to lines of business.

As plan participants retire or otherwise terminate, Wyatt has transferred their actuarial liability to the inactive segment. Wyatt also transferred assets to the degree that the actuarial liability for the originating active segment is funded. If the actuarial liability was fully funded, then Wyatt transferred an amount equal to the actuarial liability. The relevant sentence of CAS 413-50(c)(9) reads:

> "The amount of funds transferred shall be that portion of the actuarial liabilities for these inactive plan participants that have been funded."

Watson Wyatt Worldwide believes, and the auditors concur, that this means that if 100% of the liability is funded, then the asset transfer is based upon 100% of the liability. This interpretation is consistent with the actuarial and accounting practice historically used to move funds to the "retired life reserve" of a "deposit administration" or "immediate participation guarantee" insurance contract which were commonly used as funding vehicles for pension plans prior to the 1980's.

The auditors followed these established practices of Rocky Mountain. HCFA has consistently accepted these practices used by most members of the NEBA program. It strains credulity that Rocky Mountain now wants to disavow its past practices.

5. There should not have been a transfer all the active employees from the Medicare Segment prior to calculating the segment closing adjustment.

I disagree that the transfer of all active employees would cause a misstatement.

This is more of an objection to the presentation of the finding. The salient point is that CAS 413-50(c)(12) requires a determination of the difference between the market value of assets and the actuarial liability. The difference between these values algebraically will be the same regardless of whether or not an equal value associated with active participants is subtracted from both the market value of assets and the actuarial liability. The auditors' presentation is consistent with the fact that once the Medicare operations ended, the active employees in question were reassigned to other activities outside the Medicare segment.

This presentation is also consistent with the Government's view that the future employment and salaries paid to these employees are the result of management decisions by Rocky Mountain as to whether to retain these employees or not. The Government neither benefits from nor causes the future employment and salaries of these employees. This issue is discussed further under topic # 8.

6. Where asset transfers were appropriate for active employees, any transfer should include a portion of the surplus assets.

I disagree.

The auditors used the same method of transferring assets and liabilities as used by Rocky Mountain's actuary. The only explicit guidance on the amount of assets to transfer is found under CAS 413-50(c)(9) which was discussed above under topic # 4. Therefore, the auditors were correct in transferring assets equal to the actuarial liability transferred. When Rocky Mountain quotes this paragraph in its response, it seems to be ignoring the plain meaning of the word "portion".[5]

Furthermore, when assets transferred are equal to the portion of actuarial liability transferred, then any actuarial surplus that had accumulated in a segment would remain with that segment and eventually be allocated to the final cost objectives (lines of business) of that segment, regardless of whether the segment performed government, commercial, or mixed operations. Besides the guidance of CAS 413-50(c)(12), I would point out that illustration at CAS 413-60(c)(1) directly demonstrates the CAS requirement to retain any gains or losses in the segment in which they arose. This requirement implements the CASB's general concept of recognizing the causal or beneficial basis of costs. In this case, gains and losses (contract credits or charges) are recognized in the appropriate segment and allocated to the cost objectives of that segment.

The auditors, and Rocky Mountain initially consented, to the use of January 1, 1996 as the measurement date because the normal annual actuarial valuation as of that date would readily supply much of the necessary data to perform the measurement and save some of the associated administrative expense. But as discussed, regardless of whether the measurement is made as of the normal annual valuation date, the day immediately after the segment ceased operations, the operations ceased, or the day immediately before, the same segment closing adjustment would have been measured.[6]

7. Expenses and earnings allocated to the Medicare Segment should be adjusted to account for the asset adjustments outlined above.

I agree that the allocation of expenses and investment earnings are indeed dependent upon all other cost determination and allocation factors. If any cost allocations or asset determinations change, then the expenses and investments earnings would be adjusted accordingly.

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[5] "1. A section or quantity within a larger thing: a part of the whole", The American Heritage Dictionary of the English Language.

[6] Use and acceptance of the January 1, 1996 does not bar Rocky Mountain from seeking a very minor interest adjustment if HCFA and Rocky Mountain settle the audit finding based on the exact contract non-renewal date. Rocky Mountain non-renewed its Part A contract as of September 31, 1995 with a transition period through December 31, 1995.

However, to the extent that the audit report is correct, any adjustment of expenses and investment earnings is unwarranted and inappropriate.

8. A projected benefit measure of liability should be used for those active Medicare employees who transferred to the non-Medicare segment following the termination of the Medicare Segment.

I disagree.

CAS 413-50(c)(12) in effect at the time the Medicare segments closed required that the adjustment of previously determined pension costs be measured using the actuarial liability, but was silent on whether the actuarial liability recognized benefit increases due to future salary increases. Reading CAS 412 and 413 together, I note that CAS 412-50(b)(6) stated:

> "Pension cost shall be based on provisions of existing pension plans. This shall not preclude contractors from making salary projections for plans whose benefits are based on salaries and wages, or from considering improved benefits for plans which provide that such improved benefits must be made."

The language of this paragraph permits the contractor to anticipate future salary increases, but does not require that these increases be anticipated. Thus this paragraph allows the contractor to prefund a portion of the associated benefit increases and achieve a smoother, and therefore more consistent, pattern of pension costs between contract accounting periods. Anticipating salary increases while the segment is ongoing is appropriate since the salaries being anticipated will have a causal/beneficial relationship to work performed under Government contracts absent evidence to the contrary. And indeed, this is the basis on which Rocky Mountain previously determined its pension costs and allocated them to the Medicare contracts.

However, when a segment closes, there is an end to the causal/beneficial relationship between future pay raises and the Government contract(s). A contractor may make a management decision to retain productive employees and to assign them to commercial lines of business. Commercial customers then benefit from the future productivity of these retained employees and are responsible for the costs associated with the salary increases paid for the future productivity. An underlying principle of the CAS, and Government contract accounting in general, has been that there must be a causal/beneficial relationship between the incurrance of a cost and the performance of a contract before that cost can be allocated to and allowed under that contract. Thus, it is inappropriate to recognize such future salary increases when determining the actuarial liability for the CAS 413-50(c)(12) segment closing adjustment.

9. The report misstates the amount of the actuarial liabilities attributable to the Medicare Segment because the actuarial liabilities should be valued using the discount rate promulgated by the PBGC.

I disagree.

In the Gould decision, the judge states: "Appellant also argues that it was entitled to use the PBGC rates because (c)(12) states that the contractor shall make the determination in question 'irrespective of whether or not the pension plan is terminated' and 'shall give consideration to any requirements imposed by agencies of the United States Government.' The interpretation of the quoted language is a legal issue. Appellant's plans did not terminate. Appellant's interpretation, that it should proceed on the false premise that the plans had terminated when they had not, is unreasonable. Furthermore, agencies of the United States Government such as PBGC did not require appellant to use the PBGC rates. PBGC published its rates for use in connection with plan terminations."

CAS 413-50(c)(12) does not specify the interest rate to be used to determine the actuarial liability. Assumed interest rates, as well as all other actuarial assumptions, are addressed by CAS 412 which says:

> "Each actuarial assumption used to measure pension cost shall be separately identified and shall represent the contractor's best estimates of anticipated experience under the plan, taking into account past experience and reasonable expectations. The validity of the assumptions used may be evaluated on an aggregate, rather than on an assumption by assumption, basis." - CAS 412-40(b)(2)
>
> "Actuarial assumptions should reflect long-term trends so as to avoid distortions caused by short-term fluctuations." - CAS 412-50(b)(5)
>
> "If the evaluation of the validity of actuarial assumptions shows that, in the aggregate, the assumptions were not reasonable, the contractor shall: (i) identify the major causes for the resultant actuarial gains or losses, and (ii) provide information as to the basis and rationale used for retaining or revising such assumptions for use in the ensuing cost accounting period(s)." - CAS 412-50(b)(7)

Paragraphs CAS 412-40(b)(2) and 50(b)(5) make it clear that the CAS Board intended that reasonable, long-term assumptions based on past performance and future expectations be used. Nowhere in either CAS 412 or 413 did the Board provide for immediate-period termination assumptions to be used. While assumptions must be based on long-term expectations, CAS 412-40(b)(2) and 50(b)(7) provide that assumptions should be updated based on changes in future economic or population trends and expectations.

The actuarial liability used to determine the CAS 413-50(c)(12) adjustment was provided by Rocky Mountain's actuary, The Wyatt Company, and it was based on the interest and

mortality valuation assumptions used since 1985.[7] The auditors found no evidence that Rocky Mountain believed its valuation assumptions were unreasonable, although it should be noted that Wyatt had lowered the interest assumption from 9.0% to 8.0% by 1994.

In CAS 413-50(c)(12) the CAS Board states that "the determination of the actuarial liability shall give consideration to any requirements imposed by agencies of the United States Government." The work papers of the original CASB show that the Board and staff were aware that the provisions of the Employee Retirement Income Security Act of 1974 (ERISA) could require a contractor to improve plan benefits upon termination of its pension plan; i.e., fully vest all accrued benefits. The Board reasoned that when an increase in liabilities for such benefit improvements was thrust upon the contractor by the Government, equity demanded that the Government recognize that increase. However in the case of Rocky Mountain, no event, such as a full nor partial pension plan termination, occurred that required or imposed any changes to the benefits provided or to the funding of the benefits. While I agree that the CAS recognizes required benefit improvements, no such improvements were imposed.

Similarly, if the pension plan were terminated with insufficient assets, the Pension Benefit Guarantee Corporation (PBGC) would use different interest, mortality, and retirement assumptions to value the actuarial liability for the benefits which it guarantees. Because the PBGC may only invest its premiums in special securities issued by the U. S. Treasury, its expected investment return will be significantly lower than that of a professionally managed trust. In addition, the methodology used to develop the PBGC rates produces extremely conservative rates. This level of extreme conservatism is only appropriate for an insurer that must guarantee the benefit liability of plan sponsors in critical financial distress, where the insurer's only financial recourse for the unfunded benefit liability often is in bankruptcy court. When the pension plan and trust continue, the PBGC assumptions are inappropriate and unreasonable.

Because an enrolled actuary's primary duty under ERISA is to certify to the adequacy of funding of the benefits promised to the pension plan's participants, my experience has been that most pension actuaries build some degree of conservatism into their valuation assumptions. In the second exposure draft on selecting economic assumptions, the Actuarial Standards Board recognized this practice and recommended that such conservatism be explicitly addressed by an assumption for adverse deviation. At the close of the Medicare segments, Rocky Mountain chose to continue the funding of the pension liability for former segment employees through a professionally managed trust. The interest assumption is therefore properly based upon the underlying investment decision of the contractor. Rocky Mountain has made a financial decision to retain the investment risk and try to "beat" the long-term conservative interest assumption. Had Rocky Mountain actually purchased annuity contracts, only then would the costs of such

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[7] In 1985, Wyatt prepared two valuations, one based on 8.5% and one on 9.0%. The 8.5% interest assumption was used for both ERISA and CAS purposes for that year.

contracts have established the actuarial liability since the premium would have represented the value of future benefit payments to the participants.[8]

For purposes of CAS 413-50(c)(12), the actuarial liability is to be determined using an interest assumption based on past experience and long-term expectations concerning the investment yield of the underlying funding mechanism. As the judge found in the Gould decision, only requirements of agencies of the U.S. Government actually imposed should be reflected in the determination of the actuarial liability. The actuarial liability, as computed by The Wyatt Company based on valuation assumptions as of January 1, 1992, was appropriate for determining the adjustment required by CAS 413-50(c)(12).

Rocky Mountain also asserted that using the market value of assets is inconsistent with the use of ongoing actuarial assumptions. The auditors properly followed CAS 413-50(c)(12) which requires that the adjustment be calculated as the "market value of assets" less the actuarial liability. Contrary to Rocky Mountain's assertion, this is consistent with the immediate period recognition approach used to determine the adjustment amount.

Pension costs for ongoing segments are measured using the actuarial value of assets. The actuarial value of assets is typically determined based on the change in the market value of assets during the year with some portion of the asset gain or loss deferred to future periods through an amortization process.[9] Just as the use of the actuarial liability causes all liability gains and losses to be recognized in the current period, instead of deferred to future periods, the use of the market value of assets causes immediate period recognition of all asset gains and losses. The CASB recognized that when a segment was closed there would be no future accounting periods in which to adjust gains and losses, and therefore adopted the immediate period recognition for segment closings.

10. The report misstates the amount of the actuarial liabilities attributable to the Medicare Segment because the calculation of the actuarial liabilities of the Medicare Segment should consider the present value of administrative expenses.

I disagree.

The actuarial liabilities provided to the auditors by Rocky Mountain's actuary, both on an

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[8] Actually, after adjusting the premium for expected dividends, the resultant actuarial liability may have only differed from the liability used in the audit report by the cost assessed by the insurer for full risk assumption and profit.

[9] While there are many methods used to determine the actuarial value of assets, all methods share the attribute that some portion of the difference between the value of assets used for measurement of the annual cost and the true market value is deferred to future periods.

accrued benefit basis and on a projected benefit basis, were developed using the methods and assumptions that had been consistently used for determining pension costs for the Medicare contract, as well as for ERISA purposes. These assumptions and method do provide for administrative expenses. The auditors have made no adjustments to remove or change the recognition of administrative expenses as provided by Rocky Mountain's actuary.

This same issue was raised during the Gould case. In this case the judge accepted the Government's expert witness's testimony that the segment closing lowered the administrative expense because inactive employees cause less actuarial and record-keeping expenses. As discussed under the topics concerning actives and future salary levels, while Rocky Mountain did not terminate all its Medicare segment employees, the Government neither benefits from nor causes the future expense associated with Rocky Mountain's decision to retain these employees.

Please contact me at (410)-786-6381 or EShipley@HCFA.GOV if you have any questions.

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