



AUG 31 2006

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

Report Number: A-07-06-00207

Karen Abraham, Vice President of Finance
PO Box 13446
8220 N 23rd Avenue
Phoenix, Arizona 85021

Dear Ms. Abraham:

Enclosed are two copies of the Department of Health and Human Services, Office of Inspector General (OIG) report entitled "Review of Medicare Contractor's Pension Segmentation Requirements at Blue Cross Blue Shield of Arizona for the Period January 1, 1991, to January 1, 2005." A copy of this report will be forwarded to the HHS action official noted on the next page for his review and any action deemed necessary.

The HHS action official will make final determination regarding action taken on all matters in the report. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act (5 U.S.C. § 552, as amended by Public Law 104-231), OIG reports are made available to the public to the extent information contained therein is not subject to exemptions in the Act (see 45 CFR part 5).

If you have any questions or comments about this report, please do not hesitate to call me at (816) 426-3591, extension 274, or Jenenne Tambke, Audit Manager, at (573) 893-8338, extension 21, or through email at Jenenne.Tambke@oig.hhs.gov. Please refer to report number A-07-06-00207 in all correspondence.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Patrick J. Cogley".

Patrick J. Cogley
Regional Inspector General
for Audit Services

Enclosures

Page 2 – Ms. Karen Abraham

Direct Reply to HHS Action Official:

Mr. Jeff Flick
Regional Administrator, Region IX
Centers for Medicare & Medicaid Services
75 Hawthorne Street, Suite 408
San Francisco, California 94105

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF MEDICARE
CONTRACTOR'S PENSION
SEGMENTATION REQUIREMENTS
AT BLUE CROSS BLUE SHIELD
OF ARIZONA FOR THE PERIOD
JANUARY 1, 1991, TO
JANUARY 1, 2005**



Daniel R. Levinson
Inspector General

August 2006
A-07-06-00207

Office of Inspector General

<http://oig.hhs.gov>

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OAS FINDINGS AND OPINIONS

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



EXECUTIVE SUMMARY

BACKGROUND

Blue Cross Blue Shield of Arizona (Arizona) administers Medicare Part A operations under a cost reimbursement contract with the Centers for Medicare & Medicaid Services (CMS).

Starting with fiscal year 1988, CMS incorporated segmentation requirements into Medicare contracts. The Medicare contract defines a segment and specifies the methodology for the identification and initial allocation of pension assets to the segment. Additionally, the contract requires Medicare segment assets to be updated for each year after the initial allocation in accordance with Cost Accounting Standards 412 and 413.

OBJECTIVES

Our objectives were to determine if Arizona complied with the Medicare contracts' pension segmentation requirements while:

- implementing the prior audit findings, and
- updating the Medicare segment's assets from January 1, 1991, to January 1, 2005.

SUMMARY OF FINDINGS

Arizona did not correctly adjust the beginning market value of assets or comply with the Medicare contract's pension segmentation requirements when updating the segment's assets from January 1, 1991, to January 1, 2005. As a result, Arizona overstated the January 1, 2005, Medicare segment assets by \$6,070.

RECOMMENDATION

We recommend that Arizona decrease Medicare segment pension assets by \$6,070 as of January 1, 2005.

AUDITEE'S COMMENTS

Arizona agreed with our recommendation. Arizona's response is included in its entirety as Appendix B.

TABLE OF CONTENTS

	<u>Page</u>
INTRODUCTION	1
BACKGROUND	1
Arizona’s Medicare Contract.....	1
Regulations	1
OBJECTIVES, SCOPE, AND METHODOLOGY	1
Objectives	1
Scope.....	1
Methodology.....	2
FINDINGS AND RECOMMENDATION	2
MEDICARE CONTRACT AND COST ACCOUNTING STANDARDS	3
Medicare Contract.....	3
Cost Accounting Standards.....	3
PRIOR AUDIT RECOMMENDATION	3
UPDATE OF MEDICARE SEGMENT ASSETS	4
Contributions and Prepayment Credits Overstated.....	4
Benefit Payments Overstated.....	5
Net Transfers Overstated	5
Earnings and Expenses Overstated.....	5
OVERSTATEMENT OF MEDICARE SEGMENT ASSETS	6
RECOMMENDATION	6
AUDITEE’S COMMENTS	6
 APPENDIXES	
A - BLUE CROSS BLUE SHIELD OF ARIZONA STATEMENT OF MARKET VALUE OF PENSION ASSETS FOR THE PERIOD JANUARY 1, 1991, TO JANUARY 1, 2005	
B - AUDITEE’S COMMENTS	

Glossary of Abbreviations and Acronyms

Arizona	Blue Cross Blue Shield of Arizona
CAS	Cost Accounting Standards
CMS	Centers for Medicare & Medicaid Services
OIG	Office of Inspector General

INTRODUCTION

BACKGROUND

Arizona's Medicare Contract

Blue Cross Blue Shield of Arizona (Arizona) administers Medicare Part A operations under a cost reimbursement contract with the Centers for Medicare & Medicaid Services (CMS).

CMS incorporated segmentation requirements into Medicare contracts starting in fiscal year 1988. The Medicare contract defines a segment and specifies the methodology for the identification and initial allocation of pension assets to the segment. Furthermore, the contract requires Medicare segment assets to be updated for each year after the initial asset allocation in accordance with Cost Accounting Standards (CAS) 412 and 413. Finally, in claiming costs, contractors must follow cost reimbursement principles contained in the Federal Acquisition Regulation, CAS, and Medicare contract.

Regulations

The CAS 412 regulates the determination and measurement of pension cost components. 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.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

Our objectives were to determine if Arizona complied with the Medicare contracts' pension segmentation requirements while:

- implementing the prior audit recommendation, and
- updating the Medicare segment's assets from January 1, 1991, to January 1, 2005.

Scope

We reviewed Arizona's identification of its Medicare segment, and its update of Medicare assets from January 1, 1991, to January 1, 2005.

Achieving our objectives did not require us to review Arizona's overall internal control structure. However, we did review controls relating to the identification of the Medicare segment and the update of the segment assets to ensure adherence to the Medicare contract, CAS 412, and CAS 413.

We performed fieldwork at Arizona’s office in Phoenix, Arizona, during March 2006.

Methodology

In performing this review, we used information provided by Arizona’s prior and current actuarial consulting firms. The information included assets, liabilities, normal costs, contributions, benefit payments, investment earnings, and administrative expenses. Arizona was unable to provide the accrued liabilities and normal costs by participant for the years 1992 through 1994; however we were able to accept the Medicare segment accrued liabilities and normal costs as identified by Arizona. We reviewed Arizona’s accounting records, pension plan documents, annual actuarial valuation reports, and Department of Labor/Internal Revenue Service Form 5500s. In addition, the CMS Office of the Actuary staff used the documents to calculate Medicare segment assets as of January 1, 2005. We reviewed the methodology and calculations.

We performed this review in conjunction with our audit of the pension costs Arizona claimed for Medicare reimbursement (A-07-06-00216). We used the information obtained and reviewed during that audit in performing this review.

Details of the Medicare segment’s updated pension assets from January 1, 1991, to January 1, 2005, are presented as the Appendix A.

We conducted our review in accordance with generally accepted government auditing standards.

FINDINGS AND RECOMMENDATION

Arizona did implement the prior audit recommendation; however it didn’t correctly adjust the corresponding market value of assets as of January 1, 1991. In addition, Arizona did not comply with the Medicare contract’s pension segmentation requirements while updating Medicare segment assets from January 1, 1991, to January 1, 2005.

As a result, Arizona overstated the January 1, 2005, Medicare segment pension assets by \$6,070. The accumulated overstatement of Medicare segment assets is shown in Table 1.

Table 1: Summary of Asset Adjustments	
Beginning Market Value of Assets	(\$2,726)
Contributions and Prepayment Credits	(128,790)
Benefit Payments	134,942
Earnings and Expenses	(107,190)
Net Transfers	97,694
(Over)/Understatement	(\$6,070)

MEDICARE CONTRACT AND COST ACCOUNTING STANDARDS

Medicare Contract

The Medicare contract identifies a Medicare segment as:

Any organizational component of the contractor, such as a division, department, or other similar subdivision, having a significant degree of responsibility and accountability for the Medicare contract/agreement, in which:

1. The majority of the salary dollars is allocated to the Medicare agreement/contract; or,
2. Less than a majority of the salary dollars is allocated to the Medicare agreement/contract, and these salary dollars represent 40 percent or more of the total salary dollars allocated to the Medicare agreement/contract.

Furthermore, the Medicare contract states that: “The pension assets allocated to each Medicare segment shall be adjusted in accordance with CAS 413.50(c)(7).”

Cost Accounting Standards

The CAS 413.50(c)(7) requires that the asset base be adjusted by contributions, permitted unfunded accruals, income, benefit payments, and expenses. For plan years beginning on or before March 30, 1995, the CAS requires investment income and expenses to be allocated among segments in proportion to the beginning of year asset value. For plan years beginning after March 30, 1995, the CAS requires investment income and expenses to be allocated among segments based on the ratio of the segment’s weighted average value method (WAV) of assets to total company WAV of assets.

In addition, CAS 413.50(c)(8) requires an adjustment to be made for transfers (participants who enter or leave the segment) if the transfers materially affect the segment’s ratio of pension plan assets to actuarial accrued liabilities.

Furthermore, CAS 412.50(a)(4) provides that contributions in excess of the pension cost assigned to the period are recognized as prepayment credits and are accumulated at the assumed valuation interest rate until applied to future period costs. Prepayment credits that have not been applied to fund pension costs are excluded from the value of assets used to compute pension costs.

PRIOR AUDIT RECOMMEDATION

Arizona did properly adjust the actuarial value of assets as recommended in the prior audit report (A-07-92-00586); however it didn’t correctly adjust the corresponding market value of assets as of January 1, 1991. Arizona identified \$574,914 of Medicare segment market value of assets;

however the prior audit identified \$572,188 as the segment's January, 1 1991, market value of assets. Thus, Arizona overstated the market value of assets as of January 1, 1991 by \$2,726.

UPDATE OF MEDICARE SEGMENT ASSETS

Arizona did not properly account for contributions and prepayment credits, benefit payments, transfers, and earnings net expenses while updating the segment's assets to January 1, 2005.

Contributions and Prepayment Credits Overstated

Arizona's update methodology did not equitably assign pension contributions to the Medicare segment. As a result, Arizona overstated contribution and prepayments by \$128,790. The overstatement primarily occurred because Arizona's contributions exceeded the required funding of the CAS pension costs throughout the audit period. In addition, Arizona failed to identify prepayment credits in 1994, 2000, and 2001.

The audited contributions and prepayment credits are based on the assignable pension costs as calculated by the CMS Office of the Actuary. Since prepayment credits are available at the beginning of the year, they are applied first to cover current year assignable pension costs, and any remaining prepayment credits are updated with interest to the next measurement (valuation) date. Subsequent contributions are then allocated as needed to assigned pension costs as of the date of deposit.

The segment assets decreased by \$128,790 in the audited update due to differences in assigned contributions and prepayment credits. A comparison of Arizona's and our calculations of pension contributions and prepayment credits is shown in Table 2.

Table 2: Contributions & Prepayment Credits			
Year	OIG	Arizona	Difference
1991	\$0	\$2,646	(\$2,646)
1992	0	9,121	(9,121)
1993	0	24,296	(24,296)
1994	89,305	64,227	25,078
1995	0	38,010	(38,010)
1996	0	14,362	(14,362)
1999	0	20,703	(20,703)
2000	43,691	51,292	(7,601)
2001	133,210	128,217	4,993
2002	152,083	166,063	(13,980)
2003	223,500	251,463	(27,963)
2004	252,400	252,579	(179)
TOTAL	\$894,189	\$1,022,979	(\$128,790)

Benefit Payments Overstated

Arizona overstated benefit payments by \$134,942 because it duplicated a single lump sum payment as a Medicare segment benefit payment in two different years. This overstatement of benefit payments results in an understatement of the Medicare segment assets.

Net Transfers Overstated

Arizona overstated transfers out of the Medicare segment by \$97,694. It made adjustments for transfers in its update of segment assets from January 1, 1991, to January 1, 2005. However, Arizona incorrectly identified the participants who transferred in and out of the segment. As a result, Arizona understated its Medicare segment assets by \$97,694.

A comparison of Arizona's and our calculations of net asset transfers from the Medicare segment is shown in Table 3.

Year	OIG	Arizona	Difference
1991	\$65,237	\$37,199	\$28,038
1992	(142,798)	(142,798)	0
1993	97,047	97,047	0
1994	(105,105)	5,958	(111,063)
1995	(264,105)	(299,622)	35,517
1996	(14,585)	(123,051)	108,466
1997	107,741	106,314	1,427
1998	4,579	275	4,304
1999	(120,291)	(259,944)	139,653
2000	3,238	169,911	(166,673)
2001	(25,288)	(27,556)	2,268
2002	(161,919)	(19,740)	(142,179)
2003	(224,940)	(422,876)	197,936
2004	(87,024)	(87,024)	0
Total	(\$868,213)	(\$965,907)	\$97,694

Earnings and Expenses Overstated

Arizona overstated investment earnings, less administrative expenses, by \$107,190 for the Medicare segment because it used an incorrect beginning market value of assets and also incorrect contribution, prepayment credit, transfer, and benefit amounts (discussed above) to develop the Medicare asset base. In our audited update, we allocated earnings and expenses based upon the applicable CAS requirements.

OVERSTATEMENT OF MEDICARE SEGMENT ASSETS

Arizona did not ensure that the Medicare segment's assets were updated in accordance with the Medicare contract. As of January 1, 2005, Arizona overstated Medicare segment pension assets by \$6,070.

RECOMMENDATION

We recommend that Arizona decrease Medicare segment pension assets by \$6,070 as of January 1, 2005.

AUDITEE'S COMMENTS

Arizona agreed with our recommendation. Arizona's response is included in its entirety as Appendix B.

APPENDIXES

Blue Cross Blue Shield of Arizona
Statement of Market Value of Pension Assets
For the Period
January 1, 1991, to January 1, 2005

Description	Total Company	Other Segment	Medicare
Assets January 1, 1991	<u>1/</u> \$10,728,993	\$10,156,805	\$572,188
Prepayment Transfer	0	0	0
Contributions	<u>2/</u> 963,861	963,861	0
Earnings	<u>3/</u> 2,330,407	2,206,124	124,283
Benefit Payments	<u>4/</u> (713,681)	(713,681)	0
Expenses	<u>5/</u> (64,131)	(60,711)	(3,420)
Transfers	<u>6/</u> 0	(65,237)	65,237
Assets January 1, 1992	13,245,449	12,487,161	758,288
Prepayment Transfer	0	0	0
Contribution	680,588	680,588	0
Earnings	526,032	495,917	30,115
Benefit Payments	(984,638)	(980,021)	(4,617)
Expenses	(67,453)	(63,591)	(3,862)
Transfers	0	142,798	(142,798)
Assets January 1, 1993	13,399,978	12,762,852	637,126
Prepayment Transfer	0	0	0
Contribution	1,400,054	1,400,054	0
Earnings	1,363,265	1,298,446	64,819
Benefit Payments	(477,156)	(477,156)	0
Expenses	(95,476)	(90,936)	(4,540)
Transfers	0	(97,047)	97,047
Assets January 1, 1994	15,590,665	14,796,213	794,452
Prepayment Transfer	<u>7/</u> 0	(65,245)	65,245
Contributions	1,865,996	1,841,936	24,060
Earnings	89,831	84,878	4,953
Benefit Payments	(1,339,490)	(1,339,490)	0
Expenses	(79,696)	(75,302)	(4,394)
Transfers	0	105,105	(105,105)
Assets January 1, 1995	\$16,127,306	\$15,348,095	\$779,211

Blue Cross Blue Shield of Arizona
Statement of Market Value of Pension Assets
For the Period
January 1, 1991, to January 1, 2005

Description	Total Company	Other Segment	Medicare
Assets January 1, 1995	\$16,127,306	\$15,348,095	\$779,211
Prepayment Transfer	0	0	0
Contribution	1,927,101	1,927,101	0
Earnings	4,346,412	4,136,410	210,002
Benefit Payments	(719,443)	(719,443)	0
Expenses	(79,734)	(75,882)	(3,852)
Transfers	0	264,105	(264,105)
Assets January 1, 1996	21,601,642	20,880,386	721,256
Prepayment Transfer	0	0	0
Contribution	3,195,747	3,195,747	0
Earnings	3,554,685	3,451,069	103,616
Benefit Payments	(531,765)	(369,237)	(162,528)
Expenses	(113,418)	(110,112)	(3,306)
Transfers	0	14,585	(14,585)
Assets January 1, 1997	27,706,891	27,062,438	644,453
Prepayment Transfer	0	0	0
Contributions	346,885	346,885	0
Earnings	5,582,228	5,448,440	133,788
Benefit Payments	(1,639,448)	(1,639,448)	0
Expenses	(138,236)	(134,923)	(3,313)
Transfers	0	(107,741)	107,741
Assets January 1, 1998	31,858,320	30,975,651	882,669
Prepayment Transfer	0	0	0
Contribution	0	0	0
Earnings	5,027,450	4,885,211	142,239
Benefit Payments	(1,418,982)	(1,416,201)	(2,781)
Expenses	(171,475)	(166,624)	(4,851)
Transfers	0	(4,579)	4,579
Assets January 1, 1999	\$35,295,313	\$34,273,458	\$1,021,855

Blue Cross Blue Shield of Arizona
Statement of Market Value of Pension Assets
For the Period
January 1, 1991, to January 1, 2005

Description	Total Company	Other Segment	Medicare
Assets January 1, 1999	\$35,295,313	\$34,273,458	\$1,021,855
Prepayment Transfer	0	0	0
Contribution	20,703	20,703	0
Earnings	5,535,123	5,367,614	167,509
Benefit Payments	(3,062,346)	(3,062,346)	0
Expenses	(160,295)	(155,444)	(4,851)
Transfers	0	120,291	(120,291)
Assets January 1, 2000	37,628,498	36,564,276	1,064,222
Prepayment Transfer	0	(30,844)	30,844
Contribution	434,802	421,955	12,847
Earnings	(1,513,004)	(1,467,701)	(45,303)
Benefit Payments	(2,113,852)	(2,113,852)	0
Expenses	(227,265)	(220,460)	(6,805)
Transfers	0	(3,238)	3,238
Assets January 1, 2001	34,209,179	33,150,136	1,059,043
Prepayment Transfer	0	(163)	163
Contribution	10,374,404	10,241,357	133,047
Earnings	(1,778,133)	(1,723,878)	(54,255)
Benefit Payments	(2,220,271)	(2,154,958)	(65,313)
Expenses	(188,389)	(182,641)	(5,748)
Transfers	0	25,288	(25,288)
Assets January 1, 2002	40,396,790	39,355,141	1,041,649
Prepayment Transfer	0	(152,083)	152,083
Contribution	15,800,000	15,800,000	0
Earnings	(3,077,411)	(2,981,623)	(95,788)
Benefit Payments	(4,247,829)	(4,242,940)	(4,889)
Expenses	(197,712)	(191,558)	(6,154)
Transfers	0	161,919	(161,919)
Assets January 1, 2003	\$48,673,838	\$47,748,856	\$924,982

Blue Cross Blue Shield of Arizona
Statement of Market Value of Pension Assets
For the Period
January 1, 1991, to January 1, 2005

Description	Total Company	Other Segment	Medicare
Assets January 1, 2003	\$48,673,838	\$47,748,856	\$924,982
Prepayment Transfer	0	(223,500)	223,500
Contribution	16,751,562	16,751,562	0
Earnings	9,866,174	9,623,109	243,065
Benefit Payments	(4,135,728)	(4,135,728)	0
Expenses	(233,307)	(227,559)	(5,748)
Transfers	0	224,940	(224,940)
Assets January 1, 2004	\$70,922,539	\$69,761,680	\$1,160,859
Prepayment Transfer	0	(252,400)	252,400
Contribution	13,329,700	13,329,700	0
Earnings	7,277,583	7,130,035	147,548
Benefit Payments	(2,430,970)	(2,430,970)	0
Expenses	(298,268)	(292,221)	(6,047)
Transfers	0	87,024	(87,024)
Assets January 1, 2005	\$88,800,584	\$87,332,848	\$1,467,736
Per Arizona	<u>8/</u> \$88,800,584	\$87,326,778	\$1,473,806
Asset Variance	<u>9/</u> \$0	\$6,070	(\$6,070)

FOOTNOTES

- 1/ We determined the Medicare segment assets as of January 1, 1991, based upon our prior audit. The amounts shown for the other segment represent the difference between the total company and the Medicare segment. All pension assets are shown at market value.
- 2/ We obtained total company contribution amounts from the actuarial valuation reports and Department of Labor/Internal Revenue Service Form 5500s. We allocated total company contributions to the Medicare segment based on the ratio of the Medicare segment funding target divided by the total company funding target. Contributions in excess of the funding targets were treated as prepayments credits and accounted for in the other segment until needed to fund pension cost in the future.
- 3/ We obtained investment earnings from actuarial valuation reports. We allocated investment earnings based on the market value of Medicare assets at the beginning of the plan year after adjustment for transfers. For years starting with 1996, we allocated investment earnings based on the ratio of the segment's Weighted Average Value (WAV) of assets to total company WAV of assets as required by the Cost Accounting Standards.

Blue Cross Blue Shield of Arizona
Statement of Market Value of Pension Assets
For the Period
January 1, 1991, to January 1, 2005

APPENDIX A

Page 5 of 5

- 4/ We based the Medicare segment's benefit payments on actual payments to Medicare retirees. Arizona provided us with supporting documentation for benefit payment amounts to plan retirees. We used actual benefit payments for Medicare segment retirees.
- 5/ We allocated administrative expenses to the Medicare segment in proportion to investment earnings.
- 6/ We identified participant transfers between segments by comparing valuation data files provided by Arizona. Our transfer adjustment considered each participant's actuarial liability and the funding level of the segment from which the participant transferred. For transfers that occurred prior to the 1996 plan year, asset transfers reflected the funding level of the segment from which the participant transferred, based on the actuarial liability and the asset value used for cost purposes. We calculated the funding level as the assets divided by the liabilities. If the funding level was greater than one, we transferred assets equal to the participant's liability. For plan years starting with 1996, asset transfers were equal to the actuarial liability determined under the accrued benefit cost method in accordance with the CAS.
- 7/ Prepayment credits represent funds available to satisfy future funding requirements and are applied to future funding requirements before current year contributions in order to reduce interest costs to the Federal Government. Prepayment credits are transferred to the Medicare segment as needed to cover funding requirements.
- 8/ We obtained total asset amounts as of January 1, 2005, from the actuarial valuation report as prepared by Arizona's actuarial consulting firm.
- 9/ The asset variance represents the difference between our calculation of Medicare segment assets and Arizona's market value of assets.



An Independent Licensee of
the Blue Cross and Blue
Shield Association

August 17, 2006

Mr. Patrick Cogley
Regional Inspector General for Audit Services
Department of Health and Human Services
Office of Inspector General
Office of Audit Services
Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

Refer to: A-07-06-00207

Dear Mr. Cogley:

The purpose of this letter is to submit our response to the Department of Health and Human Services Office of Inspector General's draft report on the review of Blue Cross Blue Shield of Arizona's segmentation of pension assets under the Medicare business contract for the period January 1, 1991 through January 1, 2005.

We agree with the report finding that the Medicare segment pension assets are overstated and will take the following actions to ensure the report recommendations are implemented.

- 1) Make adjustments to decrease the Medicare segment pension assets by \$6,070 as of January 1, 2005.
- 2) Work with Blue Cross Blue Shield of Arizona's actuaries to ensure that Medicare segment pension assets are updated in accordance with cost accounting standards as well as Medicare contractual requirements.

We appreciate the opportunity to review and provide our comments prior to release of the final report. If you have any questions regarding our response, please contact Marty O'Reilly at 602-864-5393.

Sincerely

A handwritten signature in cursive script that reads "William Arthur".

William Arthur
Director of Finance

Cc: Jay Pinkerton, CCA Strategies LLC
Megan Seehafer, OIG/OAS
Eric Shipley, CMS
Hazel Johnson, CMS
Rosalia Teran, CMS
Mel Illagan, CMS
Tony Astorga, BCBSAZ
Susie Nash, BCBSAZ
Karen Abraham, BCBSAZ
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