

**Memorandum**

Date .NOV 25 1998
From June Gibbs Brown
Inspector General *June G. Brown*
Subject Review of the 1997 Adjusted Community Rate Proposal for a Massachusetts Risk-Based
Managed Care Organization (A-01-98-00510)
To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

The attached final report is one in a series of reports that is part of our overall review of the administrative costs planned and incurred by managed care organizations (MCO) relative to their operating a Medicare risk managed care plan. The report presents the results of our review of the adjusted community rate (ACR) proposal submitted to the Health Care Financing Administration (HCFA) by a Medicare managed care risk contractor located in Massachusetts for the 1997 contract year. The objective of these reviews was to examine the administrative cost component of the ACR proposal submitted by the MCOs, and assess whether the costs for judgmentally selected administrative cost items were appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs. Because MCOs view the use of administrative funds to be a sensitive matter and the Medicare managed care program is essentially a concentrated HCFA central office operation, we want to share these individual MCO reports directly with you.

On July 27, 1998 we issued a report entitled, "Administrative Costs Submitted by Risk-Based Health Maintenance Organizations on the Adjusted Community Rate Proposals Are Highly Inflated" (A-14-97-00202). This report examined the allocation of administrative costs on the ACR proposals for contract years 1994 through 1996. We concluded that the methodology which allowed MCOs to apportion administrative costs to Medicare was flawed and resulted in Medicare covering a disproportionate amount of the MCO's administrative costs. The attached report on selected administrative costs of a Medicare managed care risk contractor located in Massachusetts provides some insight on where some of the excess administrative costs may be used. Because of the limited scope of our review, our results cannot be projected to the universe of administrative costs submitted by the MCO.

The ACR process is designed for MCOs to present to HCFA their estimate of the funds needed to cover the costs (both medical and administrative) of providing the Medicare package of services to any enrolled Medicare beneficiary. The ACR proposal is integral to developing an MCO's benefit package, computing savings (if any) from Medicare

payment amounts, and determining additional benefits that may be provided to beneficiaries or reducing premiums that may be charged to the Medicare enrollees. Included as MCO's administrative costs are the non-medical costs associated with facilities, taxes, legal and accounting fees, and non-medical compensation and other costs incurred for the general management and administration of the business unit.

The Massachusetts MCO's ACR for 1997 included \$67,587,649 in general administrative costs. Based on our review of selected transactions totaling \$13,424,470 from the MCO's general administrative costs, we found the ACR submission included:

- \$308,189 in lobbying costs which were prohibited under the MCO's risk contract with HCFA;
- \$32,500 in entertainment costs that would not have been allowable if existing Contract Cost Principles were applied to risk-based MCOs; and
- \$1,066,833 in various administrative costs for which the MCO did not provide supporting documentation. These costs related primarily to travel and auto, meetings and dues, miscellaneous, and consulting.

These costs would not have been allowable if they were submitted by MCOs under cost contracts or if submitted by health care providers paid under a Medicare cost reimbursement system. We believe these administrative costs should not be included in the ACR proposal since this only serves to increase the ACR. An unjustifiably increased ACR adversely impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Presently, there is no statutory or regulatory authority governing allowability of costs in the ACR process for risk MCO contracts unlike other areas of the Medicare program. For example, regulations covering MCOs that contract with HCFA on a cost reimbursement basis provide specific parameters delineating allowable administrative costs for enrollment and marketing. These same guidelines, however, are not used in administering the MCO risk contracts.

Because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations addressed to the Massachusetts plan. As a result, the MCO decided not to respond to our draft report.

While this review examined only one plan, we believe that our results highlight a significant problem. Additional reviews are underway and preliminary results show there are similar findings at other MCOs. The results of these reviews will be shared with HCFA in the coming months so that appropriate legislative changes can be considered. We invite HCFA comments on our review as it proceeds.

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If you have any questions, please contact me or have your staff contact George M. Reeb, Assistant Inspector General for Health Care Financing Audits, at (410) 786-7104. To facilitate identification, please refer to Common Identification Number A-01-98-00510 in all correspondence relating to this report.

Attachment

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF THE 1997 ADJUSTED
COMMUNITY RATE PROPOSAL FOR A
MASSACHUSETTS RISK-BASED
MANAGED CARE ORGANIZATION**



JUNE GIBBS BROWN
Inspector General

NOVEMBER 1998
A-01-98-00510

**Memorandum**

NOV 25 1998

Date

June Gibbs Brown
Inspector General

From

Subject

Review of the 1997 Adjusted Community Rate Proposal for a Massachusetts Risk-Based Managed Care Organization (A-01-98-00510)

To

Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

This report presents the results of our review of the adjusted community rate (ACR) proposal submitted to the Health Care Financing Administration (HCFA) by a Medicare managed care risk contractor located in Massachusetts for the 1997 contract year. The objective of our review was to examine the administrative cost component of the ACR proposal submitted by the Massachusetts managed care organization (MCO), and assess whether the costs were appropriate when compared to the Medicare program's general principle of paying only reasonable costs.

The Medicare ACR process is designed for MCOs to present to HCFA their estimate of the funds needed to cover the costs of providing the Medicare package of covered services to any enrolled Medicare beneficiary. The MCO's anticipated or budgeted funds are calculated to cover medical and administrative costs of the plan for the upcoming year and must be supported by the individual MCO's operating experiences related to utilization and expenses.

The Massachusetts MCO's ACR for 1997 included \$67,587,649 in general administrative costs. Based on our review of selected transactions totaling \$13,424,470 from the MCO's general administrative costs, we found the ACR submission included:

- \$308,189 in lobbying costs which were prohibited under the MCO's risk contract with HCFA;
- \$32,500 in entertainment costs that would not have been allowable if existing Contract Cost Principles were applied to risk-based MCOs; and
- \$1,066,833 in various administrative costs for which the MCO did not provide supporting documentation. These costs related primarily to travel and auto, meetings and dues, miscellaneous, and consulting.

These costs would not have been allowable if they were submitted by MCOs under cost contracts or if submitted by health care providers paid under a Medicare cost reimbursement

system. The effect of including costs in the ACR proposal that would be unallowable under Contract Cost Principles reduces any potential savings from the Medicare payment amounts. These savings could in turn be used to make available additional benefits for Medicare beneficiaries or for a reduction in premium amounts.

This audit is part of a nationwide review of the ACR process and is being performed at several other MCOs. Based on the results of our reviews, we will be making recommendations to HCFA as to whether specific criteria should be applied to the costs reported by the MCO. Presently, except for lobbying costs, there are no cost principles governing the allowability of costs in the ACR process unlike other areas in the Medicare program.

INTRODUCTION

BACKGROUND

Medicare payments to risk-based MCOs are based on a prepaid capitation rate. This rate reflects the estimated costs that would have been incurred by Medicare on behalf of enrollees of the MCO if they received their covered services under fee-for-service Medicare. Risk contractors are required by section 1876 of the Social Security Act to compute an ACR proposal and submit it to HCFA prior to the beginning of the MCO's contract period. The HCFA encourages the plans to support their ACR proposal with the most current data available. The Medicare ACR process is designed for MCOs to present to HCFA their estimate of the funds needed to cover the costs (both medical and administrative) of providing the Medicare package of covered services to any enrolled Medicare beneficiary.

The MCO calculates its ACR using as a basis its commercial rates adjusted to account for differences in the cost and use of services between Medicare and commercial enrollees. The development of a base rate is the first step of the process. The base rate is the amount that the MCO will charge its non-Medicare enrollees during the contract period. The next step in the process is to develop adjustments to arrive at the initial rate which is the rate the plan would have charged its commercial members if the commercial package was limited to Medicare coverage. The adjustments eliminate the value of those services not covered by Medicare that were included in the base rate or add the value of covered Medicare services not included in the base rate.

After the calculation of the initial rate, the rate is multiplied by utilization factors to reflect differences between Medicare members and non-Medicare members with regard to volume, intensity, and complexity of services. This last calculation results in the ACR. If the average Medicare payment amount is greater than the ACR, a savings is noted. The MCO is required to use this savings to either improve its benefit package to the Medicare enrollees, reduce the Medicare enrollee's premium, or contribute to a benefit stabilization fund. With regard to the inclusion of costs, according to the MCO Manual, all assumptions, cost data, revenue requirements, and other elements used by MCOs in the ACR proposal calculations must be consistent with the calculations used for the premiums charged to non-Medicare

enrollees. The MCO cost data will be especially important due to the changes in the ACR proposal brought about by the Balanced Budget Act of 1997. This information will be used as the basis for calculating an amount the MCO will charge Medicare enrollees for a benefit package.

SCOPE

Our review was performed in accordance with generally accepted government auditing standards. The objective of our review did not require us to test the internal control structure at the MCO. Due to the limited scope of our review, our results cannot be considered representative of the universe of administrative costs submitted by the MCO. We performed our field work at the MCO's plan office in Massachusetts during June and July 1998.

The objective of our review was to examine the general administrative cost component of the ACR proposal submitted by the MCO, and assess whether the costs were appropriate when compared to the Medicare program's general principle of paying only reasonable costs.

To achieve our objective, we:

- applied the Federal Acquisition Register (FAR), Part 31, Contract Cost Principles and the Health Maintenance Organization (HMO) manual, Part 4400, Cost Apportionment for HMOs to selected cost categories;
- discussed and reviewed with the MCO officials their ACR proposal process and how their administrative costs were derived;
- reconciled MCO's administrative costs reported in its general ledger to those costs reported in its financial statements and to the ACR; and
- selected categories of administrative costs which traditionally have been shown to be problematic areas in the Medicare fee-for-service program.

We reviewed the MCO's 1995 financial records which were used as support for the 1997 ACR proposal. Total general administrative costs of \$67,587,649 included the non-medical costs associated with facilities, taxes, legal and accounting fees, and non-medical compensation. From the \$67.58 million in general administrative costs, we selected a judgmental sample of 289 items for review totaling \$13,424,470 (See Attachment I). Most of our selections of administrative costs for review were from the following general ledger accounts: meetings/dues, miscellaneous, professional, and other fees. We requested the corresponding supporting documentation for the items selected, including paid invoices and journal entries.

We provided the MCO with a draft copy of our report dated August 26, 1998. Because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations

addressed to the Massachusetts plan. As a result, the MCO decided not to respond to our draft report.

FINDINGS AND RECOMMENDATIONS

Presently, except for lobbying costs, there are no cost principles governing the allowability of costs in the ACR process unlike other areas in the Medicare program. Based on our selection of 289 transactions for review totaling \$13,424,470 from the MCO's general administrative costs, we found the administrative cost component of the 1997 ACR proposal included: (1) \$308,189 in lobbying costs; (2) \$32,500 in entertainment costs; and (3) \$1,066,833 in various administrative costs for which the MCO did not provide supporting documentation. If FAR Contract Cost Principles were applied to risk-based MCOs, then these costs should have been eliminated when computing the ACR.

Lobbying Costs

We reviewed \$287,330 in association dues paid to the Massachusetts Association of HMOs (MAHMO) and \$130,370 in membership dues paid to the Group Health Association of America (GHAA). We found that: (1) the total of \$287,330 in MAHMO association dues was attributable to lobbying activities; and (2) \$20,859, or 16 percent of the \$130,370, in payments for GHAA membership dues were related to lobbying activities. According to Article IX, section D of the MCO contract between HCFA and the MCO, there is a prohibition against the use of HCFA funds to influence legislation or appropriations. This contract provision incorporates section 31.205-22 of the FAR, which defines unallowable lobbying and political activity costs. The FAR states that costs incurred for contributing to a political party, campaign, or political action committee are unallowable. Therefore, these costs should have been eliminated when computing the ACR.

Entertainment Costs

We reviewed employee function costs associated with a "winter outing" and a "holiday party" and identified entertainment costs incurred for the benefit of employees at selected functions. These entertainment costs totaling \$32,500 would have been unallowable if cost principles and procedures for the pricing of contracts, such as the ACR proposal, were in effect. As a result, these costs would have been eliminated when computing the ACR. According to the FAR, section 31.205-14, entertainment costs are unallowable. The FAR states that costs of amusements, diversions, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation and gratuities are unallowable.

Unsupported Costs

The MCO did not provide documentation to support 107 of the 289 sampled transactions totaling \$1,066,833. These costs related primarily to travel and auto, meetings and dues, miscellaneous, and consulting. These costs were used to construct the MCO's ACR

proposal. However, documentation to support these charges was either missing or not sufficient enough to support the costs charged. If cost principles were in effect, these charges would be unallowable. According to the FAR Contract Cost Principles for commercial organizations, section 31.201-2, a contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed had been incurred, are allocable to the contract, and comply with applicable cost principles.

Recommendations

Due to the absence of criteria for inclusion of costs on the ACR proposal, there are no recommendations addressed to the Massachusetts MCO. This audit is part of a nationwide review of the ACR process and is being performed at several other MCOs. The results of these reviews will be shared with HCFA in the coming months so that appropriate legislative changes can be considered.

The Massachusetts MCO Comments

We provided the MCO with a copy of our draft report dated August 26, 1998. Since there were no cost principles governing the allowability of costs in the ACR process and the fact that there were no recommendations addressed to the Massachusetts MCO, they decided not to respond.

Review of Administrative Costs at a Massachusetts MCO

<u>General Ledger Accounts Selected for review</u>	<u>Total Dollar Amount Selected for Review</u>	<u>Total Dollar Amount of Unsupported Costs</u>	<u>Total Dollar Amount of Questioned Costs</u>
Travel & Auto:	186,693	159,989	0
Meetings/Dues:	659,287	55,649	308,189
Miscellaneous:	282,457	129,139	0
Professional:	221,067	24,400	0
Consulting Fees:	1,176,922	495,786	0
Other Fees:	7,633,937	30,575	0
Advertising:	212,445	45,818	0
Promotional:	645,080	63,752	0
Employee Related:	54,355	16,294	32,500
Taxes:	2,179,374	45,431	0
Depreciation/Leasehold:	172,853	0	0
TOTAL:	\$13,424,470	\$1,066,833	\$340,689