

**Memorandum**

Date . OCT 24 1994

From June Gibbs Brown  
Inspector General *June Gibbs Brown*

Subject Follow-up Audit of the Health Care Financing Administration's Use of Bid Proposal Audits of Peer Review Organizations (A-03-93-03001)

To Bruce C. Vladeck  
Administrator  
Health Care Financing Administration

Attached are two copies of our final report entitled, "Follow-up Audit of the Health Care Financing Administration's Use of Bid Proposal Audits of Peer Review Organizations." The primary purpose of this audit was to determine if the Health Care Financing Administration (HCFA) had implemented the recommendations in our prior audit report. And, if so, did these actions result in the Peer Review Organizations (PRO): (1) reducing the amount of unsupported costs included in their bid proposals and (2) correcting the procedural deficiencies identified by our audits.

In a prior audit report (A-14-91-00343) issued in December 1992, we reported the results of 12 audits of PRO bid proposals that HCFA requested us to perform. We reported that \$43.7 million (about 22 percent) of the proposed costs of \$196 million was unsupported. We also reported that HCFA had no systematic method of informing PROs of the Office of Inspector General's (OIG) historical findings nor a follow-up mechanism to ensure that PROs corrected procedural deficiencies identified by our audits. We recommended that HCFA insert appropriate language in future requests for proposal (RFP) alerting PROs to our past findings and establish the system(s) needed to monitor corrective action taken by the PROs.

Our current audit showed that HCFA had inserted the appropriate language in the RFP but did not take the steps required to monitor the PROs' corrective action. Furthermore, the results of 49 bid proposal audits completed subsequent to the prior audit report showed that PROs continue to include unsupported costs in their bid proposals, and at a rate higher than previously reported. We determined that of the \$769.8 million of costs proposed by the PROs, \$266.4 million, or about 35 percent, was not supported by the necessary documentation. We also determined that some PROs continue to have deficiencies in their internal control systems.

We believe additional action is needed for PROs to improve the quality of their bid proposals rather than to rely on HCFA and OIG to identify unsupported costs included in these proposals. The OIG developed a "Proposal Guidance Book" which clarifies, in specific detail, the documentation needed to support proposed costs. We tested the "Proposal Guidance Book" during nine of our recent bid proposal audits and the results were extremely successful. The PROs are receptive to the use of the "Proposal Guidance Book" because it provides them detailed information on the documentation needed to support their proposed costs. We are in favor of it because it allows us to conduct audits with fewer resources, and still comply with generally accepted government auditing standards while also meeting the needs of HCFA.

Because of the success of the "Proposal Guidance Book" in the nine PRO bid proposal audits, OIG is offering its use to all PROs. We believe, however, that the "Proposal Guidance Book" could be more useful as an up-front control over the quality of bid proposals submitted by the PROs. Used in this manner, it should enable PROs to prepare better and more precise bid proposals, and reduce the amount of unsupported costs included in these proposals.

Therefore, we are recommending that HCFA incorporate the use of the "Proposal Guidance Book" in the RFP process, and require PROs to complete it, attach the required documentation to it, and make it available during the course of the award process.

Concerning PROs internal controls, we are recommending that HCFA develop a systematic approach for monitoring PROs' corrective action plans for procedural deficiencies noted in our audit reports.

On August 17, 1994, HCFA responded to a draft of this audit report. The HCFA generally agreed with our recommendations. The response, however, indicated that HCFA believed that requiring PROs to submit the documentation required by the "Proposal Guidance Book" would not be feasible because there would be an increase in the paperwork required to respond to the RFP. Consequently, we revised the recommendation made in the draft audit report to satisfy the concerns expressed by HCFA.

The HCFA response also stated that there was not enough information in the draft audit report to determine if the current monitoring efforts would be sufficient. The HCFA has made continuous improvements to the RFP process. While we agree that the availability of data outlined in the HCFA response may be beneficial in monitoring certain activities, we do not see how this particular data would be of benefit in reviewing the corrective action plans of PROs for procedural deficiencies.

Page 3 - Bruce C. Vladeck

We would appreciate your views and the status of any further action taken or contemplated on our recommendations within the next 60 days. If you have any questions, please call me or have your staff contact George M. Reeb, Assistant Inspector General for Health Care Financing Audits at (410) 966-7104.

To facilitate identification, please refer to Common Identification Number A-03-93-03001 in all correspondence relating to this report.

Attachments

**Department of Health and Human Services**

**OFFICE OF  
INSPECTOR GENERAL**

**FOLLOW-UP AUDIT OF THE HEALTH  
CARE FINANCING ADMINISTRATION'S  
USE OF BID PROPOSAL AUDITS OF  
PEER REVIEW ORGANIZATIONS**



**JUNE GIBBS BROWN**  
Inspector General

**OCTOBER 1994**  
A-03-93-03001

**Memorandum**

Date . OCT 24 1994

From June Gibbs Brown  
Inspector General *June G Brown*

Subject

To Follow-up Audit of the Health Care Financing Administration's Use of Bid Proposal Audits of Peer Review Organizations (A-03-93-03001)

Bruce C. Vladeck  
Administrator  
Health Care Financing Administration

This final audit report provides you with the results of our follow-up audit of the Health Care Financing Administration's (HCFA) use of bid proposal audits of Peer Review Organizations (PRO) conducted by the Office of Inspector General (OIG). The primary purpose of this follow-up audit was to determine if HCFA implemented the recommendations made in our prior report, and if so, did these actions result in: (1) a reduction of unsupported costs being included in bid proposals submitted by the PROs and (2) an elimination of procedural deficiencies in PROs' accounting systems and internal controls that were previously identified in OIG audits.

Our prior audit<sup>1</sup> showed that PROs were including in their bid proposals a significant amount of unsupported costs that we identified through our bid proposal audits. Twelve of these audits identified \$43.7 million of unsupported costs, or about 22 percent of the total costs of \$196 million proposed by the PROs. We also noted that 17 of 53 OIG bid proposal audits reported procedural deficiencies in the PROs' accounting systems and internal controls. We concluded that HCFA did not have a comprehensive program to reduce the occurrences of unsupported costs in PRO bid proposals, or to monitor the actions taken by PROs to correct the procedural deficiencies.

We recommended that HCFA include in future requests for proposals (RFP) for PRO contract awards, language to alert PROs of unsupported costs found in our bid proposal audits. We also recommended that HCFA determine if our suggested procedural improvements made in prior PRO audit reports were implemented by the PROs and, institute procedures to effectively monitor PRO responses to procedural deficiencies noted in current and future bid proposal audit reports. The HCFA generally agreed with our recommendations.

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<sup>1</sup> Office of Inspector General Assessment of the Usage of Bid Proposal Audits of Utilization and Quality Control Peer Review Organizations CIN: A-14-91-00343, December 1992.

Our follow-up audit showed that HCFA did make the necessary language change to the RFPs, but procedures had not yet been established to monitor the PROs' implementation of corrective action on prior audit findings.

The HCFA took some corrective action but the rate of unsupported costs in PRO bid proposals continues to rise. Action is needed to emphasize that the burden of supporting costs is on the PROs and not on HCFA or OIG.

Our follow-up audit also showed that PROs continued to include unsupported costs in their bid proposals, and at a higher rate than previously reported. Recent audits of 49 bid proposals totaling about \$769.8 million in proposed costs (fees not included) resulted in identifying unsupported costs of \$266.4 million, or about 35 percent of the costs proposed by the PROs.

In this report we are recommending an alternative method of ensuring that more PROs fully support their proposed costs. This alternative method, which takes advantage of a "Proposal Guidance Book" developed by OIG, places the responsibility where it belongs-- on the PROs, and not so much on HCFA through monitoring or OIG through audits. The results of a recent test of the usefulness of the "Proposal Guidance Book" in our audits at nine PROs were extremely favorable. The PROs are receptive to the "Proposal Guidance Book" because it provides them detailed information on the documentation needed to support their proposed costs. We are in favor of it because it allows us to conduct audits in accordance with generally accepted government auditing standards with fewer resources.

Because of the success of the use of the "Proposal Guidance Book," in our bid proposal audits, OIG is offering this alternative method of audit to all PROs. We believe, however, that the "Proposal Guidance Book" could be even more useful if it were used as an up-front control over the quality of the bid proposals prepared by the PROs. Used in this manner, the "Proposal Guidance Book" should enable PROs to prepare better and more precise bid proposals. It should also, in time, reduce the amount of unsupported costs included in the bid proposals and, therefore, also reduce the need for HCFA to monitor corrective actions of the PROs.

Therefore, we are recommending that HCFA require all PROs to complete the "Proposal Guidance Book" as part of the bid proposal, and make it available during the course of the award process.

Concerning PROs internal controls, we are recommending that HCFA develop a systematic approach for monitoring PROs' corrective action plans for procedural deficiencies noted in our audit reports.

## BACKGROUND

The Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248), commonly referred to as TEFRA, requires that the Department of Health and Human Services (HHS) enter into agreements with private contractors to perform as PROs as defined by title XI of the Social Security Act (the Act) to provide for utilization and quality control reviews. The HHS, through HCFA, has entered into contracts with PROs across the country.

The HCFA is responsible for administering and overseeing the PRO program through its Office of Peer Review in the Health Standards and Quality Bureau. Incumbent and prospective PROs submit business proposals (hereafter referred to as bid proposals) to HCFA's Division of Health Standards Contracts. These proposals represent each offeror's estimated cost of functioning as the PRO for a specific State or geographic area for the duration of the contract.

Under the contracts with HCFA, PROs are required to operate a system to eliminate unreasonable, unnecessary, and inappropriate care provided to Medicare beneficiaries, and to assure the quality of services for which payment may be made, in whole or in part, under title XVIII of the Act. In addition, title XVIII and the Code of Federal Regulations, title 42, part 466 and part 412.44 require hospitals seeking Medicare reimbursement to enter into agreements with PROs to review on an ongoing basis, the quality, necessity, reasonableness, and appropriateness of health care services furnished under Medicare.

At HCFA's request, we have conducted audits of 49 bid proposals submitted by PROs, and have furnished the results to HCFA for its use in negotiating contracts. The objectives of these bid proposal audits are to: (1) review and evaluate the reasonableness of both the costs proposed by prospective contractors and their supporting bid estimating procedures, and (2) determine the adequacy of their respective accounting systems and internal controls. Unlike prior years' contracts that were fixed price, the current contracts are cost reimbursable.

## SCOPE OF AUDIT

The primary objective of this follow-up audit was to determine if HCFA implemented the recommendations in our prior report and, if so, whether the actions were effective in:

- (1) a reduction of unsupported costs being included in bid proposals submitted by PROs

and (2) an elimination of procedural deficiencies in PROs' accounting systems and internal controls.

As part of this audit, we summarized the results of our most recent 49 bid proposal audits that were conducted in Fiscal Year 1993. Nine of these audits were completed using the "Proposal Guidance Book" as part of a project to develop an alternate method of performing PRO bid proposal audits more efficiently and without sacrificing the quality of the audits. We also performed work at HCFA's headquarters in Baltimore, Maryland.

Our audit was performed in accordance with generally accepted government auditing standards. The objectives of this limited scope audit, however, did not include an assessment of HCFA's internal controls over the PRO program.

On August 17, 1994, HCFA responded to a draft of this audit report. The HCFA generally agreed with our recommendations. The response, however, indicated that HCFA believed that requiring PROs to submit the documentation required by the "Proposal Guidance Book" would not be feasible because there would be an increase in the paperwork required to respond to the RFP. Consequently, we revised the recommendation made in the draft report to satisfy the concerns expressed by HCFA. The HCFA response also stated that there was not enough information in the draft report to determine if the current monitoring efforts would be sufficient.

Our comments on the HCFA response are presented at the end of this report. The HCFA response in its entirety is presented as an appendix to this report.

## **RESULTS OF PRIOR AUDIT**

Our prior audit included the results of 12 audits of bid proposals totaling \$196 million in proposed costs. The audits identified unsupported costs of \$43.7 million, or about 22 percent of the costs proposed by the PROs. Salaries and fringe benefits, as single cost categories, consistently accounted for the largest portion of unsupported costs in the PROs' bid proposals. On average, salaries and fringe benefits represented nearly 48 percent of the total costs we considered unsupported. Specifically, PRO bid proposals:

- used excessive inflation rates to calculate salary and fringe benefit increases,
- inappropriately included salaries and fringe benefits for unfilled positions, and
- included excessive salaries and fringe benefits for top management.

We found that HCFA had discussed these items during current negotiations but had not used the RFPs as a means to inform PROs of OIG's historical findings. Further, an analysis of 53 bid proposal audits issued in prior years showed that 17 of the 53 audits identified procedural deficiencies involving PRO accounting systems or internal controls. The HCFA did not have a follow-up mechanism to ensure that PROs corrected these procedural weaknesses.

We recommended that HCFA insert into future RFPs for PRO contract awards a statement indicating that OIG audit reports show significant problems with amounts proposed for salaries and fringe benefits and that particular care should be taken in the development of these costs in the bid proposal. We also recommended that HCFA determine if our suggested improvements made in prior audits were implemented by the PROs, and to institute procedures to effectively monitor PRO responses to reported deficiencies in their accounting system and internal controls. The HCFA agreed with these recommendations.

## **RESULTS OF FOLLOW-UP AUDIT**

Our audit showed that HCFA had inserted appropriate alert language into the RFP but had not taken the necessary actions regarding the reported deficiencies in accounting systems and internal controls. Our analysis of the results of 49 bid proposal audits made since our prior audit report to HCFA showed that PROs continued to include unsupported costs in their bid proposals, and that deficiencies in internal controls remained in several of the PROs previously identified as having these weaknesses.

### **Unsupported Costs**

At HCFA's request we conducted audits of 49 bid proposals submitted by PROs. The proposed costs, excluding fees, in these proposals totaled about \$769.8 million. We identified unsupported costs totaling \$266.4 million, or about 35 percent of the total costs proposed. This represents an increase of 13 percent over previously reported results.

Of the unsupported costs, about \$93.4 million, or 35 percent of the unsupported costs, represented salaries and fringe benefits. While it appears as if the alert language inserted into the RFP had some positive affect--a reduction of 13 percent from previously reported results--the unsupported costs remain significant.

We recognize that during the negotiation process, the PRO has another opportunity to support costs previously identified as being unsupported. It should be noted, however, that based on our analysis of contract awards made by HCFA, the majority of unsupported costs identified through audit appears to have remained unsupported

throughout the negotiations and was eliminated by HCFA from the contract award. Of the 36 audits involving successful bidders, we identified \$158.6 million of unsupported costs, and HCFA negotiated reductions in the proposed costs totaling \$148.7 million. Based on the difference between the amount of the bid proposal and the amount of the contract award, limited to the amount of the unsupported costs identified by audit, we believe that our audits contributed in part along with skillful HCFA negotiators to \$113.9 million of the cost reductions.

### **Procedural Deficiencies**

Our bid proposal audits continue to identify deficiencies in the PROs' accounting systems and internal controls. Of the 46 audits that included these 2 areas in their scope, 27 audits reported deficiencies. This represents about 59 percent of the audits versus 32 percent (17 of 53 completed audits) reported in our prior audit.

The deficiencies we noted included:

- lack of accounting manuals,
- lack of procedures to assure that services are procured in the most cost efficient manner,
- failure to comply with written policies and procedures, and
- failure to ensure an adequate segregation of duties.

Included in our current round of audits were 14 of the 17 PROs that had prior deficiencies reported in their internal controls. Our most recent audits showed that five of these PROs had corrected the reported deficiencies. However,

- there were six PROs which had internal control systems that were generally adequate but still had deficiencies that needed to be corrected. The weaknesses included undocumented internal controls and a lack of separation of duties.
- there were three PROs which had significant internal control weaknesses. The weaknesses included lack of procurement policies, inadequate travel policy, and inadequate controls to ensure proper classification of incurred costs.

**"Proposal Guidance Book" Developed by OIG**

Based on our current audits, it is clear that PROs continue to routinely include unsupported costs in their bid proposals. It appears that the onus is primarily on HCFA and OIG to identify these costs and eliminate them from the final

contract. We believe that the responsibility for supporting costs should be placed more fully on the PROs, and not on HCFA through monitoring or OIG through audit. One method of doing this is to require PROs to complete the "Proposal Guidance Book" developed by OIG.

Incorporation of OIG's "Proposal Guidance Book" in the RFP process should help PROs prepare more precise bid proposals.

The "Proposal Guidance Book" provides PROs detailed guidance on the type of documentation needed to support the most common cost categories, both direct and indirect costs, included in most bid proposals. Each section provides a description of the type of cost documentation that is required for each specific cost category, supplemented in most cases by specific examples. The "Proposal Guidance Book" does not place an undue burden on PROs because the documentation requested should already have been developed during the preparation of the bid proposal, and would have been requested by our auditors during the course of a subsequent audit.

The OIG recently tested the usefulness of the "Proposal Guidance Book" at nine PROs and determined that there were several advantages to its use. From the PROs' point of view, the "Proposal Guidance Book" enabled them to better understand the documentation required to support proposed costs. It should, in the future, help them prepare better and more precise bid proposals.

From the OIG's point of view, it enabled us to conduct audits in accordance with generally accepted government auditing standards at a considerable savings to our staff resources and travel funds. The test at the nine PROs was entirely voluntary on their part. We have indications that the majority of PROs are interested in using the "Proposal Guidance Book" as part of the audit process. The OIG has, therefore, provided this option to all PROs, on a voluntary basis.

## CONCLUSIONS AND RECOMMENDATIONS

Our follow-up audit showed that PROs continued to include unsupported costs in their bid proposals, in fact the rate of unsupported costs increased from 22 percent of the total proposed costs as previously reported to 35 percent identified in our most recent 49 audits. There is also a need for PROs to correct procedural deficiencies identified in our audits.

In times of Government downsizing, it may not be practical to assume that HCFA and OIG can continue to expend the necessary resources to monitor and audit the PROs. The OIG has taken some steps to alter its audit process by introducing the use of the "Proposal Guidance Book" to all PROs on a voluntary basis. We believe it would be more useful if the "Proposal Guidance Book" was incorporated into the RFP process. This would essentially enable PROs to fully support the proposed costs rather than to rely so much on HCFA and OIG resources to identify and eliminate these costs.

Therefore, we recommend that HCFA:

1. Incorporate the "Proposal Guidance Book" in the RFP process and require all PROs to make it available during the course of the award process. The OIG will gladly work with HCFA to implement this recommendation, and will provide whatever additional information is needed regarding the "Proposal Guidance Book."
2. Develop a systematic approach for monitoring PROs' corrective action plans for procedural deficiencies noted in our audits.

### HCFA Response and OIG Comments

The HCFA generally agreed with the recommendations made in our draft audit report. The HCFA reply expressed concerns about the volume of paper that would have to be submitted in response to the recommendation made in our draft audit report concerning the submittal of information in response to the RFP. The response also indicated that the draft report did not contain enough information in certain instances. Comments on each of the recommendations are presented below.

Recommendation 1

The HCFA officials concurred in principle with our recommendation. They agreed that the use of the "Proposal Guidance Book" would be a beneficial step in improving the bid proposal process. They indicated that they needed further discussion among HCFA, PROs, and OIG before determining whether to implement the recommendation contained in the draft audit report.

We subsequently met with the appropriate HCFA officials and agreed to make a change to the draft audit report where we recommended that PROs be required to submit the data required by the "Proposal Guidance Book" with the RFP. As agreed, we modified the recommendation in the draft audit report to incorporate the "Proposal Guidance Book" in the RFP process and require all PROs to make it available during the course of the award process. We will continue to be available to discuss the best way for PROs to make use of the "Proposal Guidance Book".

Recommendation 2

The HCFA officials concurred with this recommendation, however, they indicated that there was not enough information in the draft audit report to determine if its current monitoring efforts would meet OIG standards.

The reply indicated that HCFA has made continuous improvements to the RFP process, including the implementation of the budget work group consisting of members from HCFA and the PROs. The response also indicated that HCFA has developed an electronic system that PROs use to submit their financial data. This system allows HCFA to receive electronic best and final offers and vouchers. The HCFA can also download information and perform various types of cost analyses from the information received.

While we agree that the availability of data such as outlined in the HCFA response may be beneficial in monitoring certain activities of the PROs, we do not see how this particular data would be of benefit in reviewing the corrective action plans of PROs for procedural deficiencies noted in our individual audit reports.

This audit report cites specific examples of procedural deficiencies that continue to exist at various PROs. Our initial report also provided specific examples of the procedural deficiencies we noted and the same recommendation for the development of a systematic approach for monitoring PROs' corrective action plans.

Page 10 - Bruce C. Vladeck

The steps taken by HCFA to improve the RFP process do not appear to be responsive to the recommendation that we are making. We are willing to meet with the appropriate HCFA staff to provide additional information on our recommendation, or to provide any other additional information that may be useful in developing a system that will improve the monitoring of PRO corrective action plans for procedural findings noted in our audit reports.

The HCFA comments have been summarized and incorporated in this report, and are presented in their entirety as an appendix to this report.



DEPARTMENT OF HEALTH & HUMAN SERVICES

Health Care  
Financing Administration

## Memorandum

Date **AUG 17 1994**  
From **Bruce C. Vladeck**   
Administrator  
Subject **Office of Inspector General (OIG) Draft Report: "Follow-up Audit of the Health Care Financing Administration's (HCFA) Use of Bid Proposal Audits of Peer Review Organizations" (A-03-93-03001)**  
To **June Gibbs Brown**  
Inspector General

We reviewed the above-referenced report in which OIG found that Peer Review Organizations (PROs) continue to include unsupported costs in their bid proposals, and found that there is a need for PROs to correct procedural deficiencies.

We agree with the report's recommendation to include language to alert PROs that OIG audit reports showed unsupported costs in the PROs' bid proposals. We implemented the recommendation to insert a statement in future requests for proposals for PRO contracts, indicating OIG's findings about problems with amounts proposed for salaries and fringe benefits. In addition, we placed salary and inflation caps in all PRO contracts. We agree that monitoring PROs' corrective actions is important, and we made several improvements in monitoring PRO activity.

Thank you for the opportunity to review and comment on this draft report. Our detailed comments on the report findings and recommendations are attached for your consideration. Please contact us at your earliest convenience if you would like to discuss our comments and response.

Attachment

**Comments of the Health Care Financing Administration (HCFA)  
on Office of Inspector General (OIG) Draft Report:  
"Follow-up Audit of the Health Care Financing Administration's  
Use of Bid Proposal Audits of Peer Review Organizations"  
(A-03-93-03001)**

**Recommendation 1**

OIG recommends that HCFA incorporate the "Proposal Guidance Book" in the Requests for proposal (RFP) process and require all Peer Review Organizations (PROs) to attach it and the required documentation to their bid proposals submitted to HCFA.

**HCFA Response**

We concur with this recommendation and will include language to alert PROs that audit reports showed unsupported costs in the PROs' bid proposals. We also agree with the recommendation to insert a statement in future RFPs for PRO contract awards, indicating OIG's findings of problems with amounts proposed for salaries and fringe benefits. HCFA will continue to closely analyze PRO contract business proposals to uncover and eliminate unsupported and unnecessary costs. HCFA is reviewing the ramifications of including the "Proposal Guidance Book" in the RFP process. HCFA, the PROs, and OIG need to discuss this further before a decision is made whether to implement it.

**Recommendation 2**

OIG recommends that HCFA develop a systematic approach for monitoring PROs corrective action plans for procedural deficiencies noted in OIG's audits.

**HCFA Response**

The discussion of the recommendation in the report is not detailed enough for us to determine if our current monitoring effort would meet OIG's standards. We suggest that OIG provide more specifics about the recommendation so we can evaluate it. However, HCFA has continuously made improvements to the RFP process. For example, we implemented a budget work group (team) consisting of members from HCFA and the PROs. The team formulates various cost containment measures that PROs apply in their RFP. This team is now staffing and costing out the entire fifth round PRO contract. HCFA has also implemented an electronic system that the PROs use to submit their financial data. This system allows HCFA to receive electronic best and final offers and vouchers. HCFA can also download information and perform various types of cost analyses from the information received.