

**Memorandum**

JUL 19 2001

Date

*Michael F. Mangano*

From

Michael F. Mangano  
Acting Inspector General

Subject

Review of the Administrative Cost Component of the Adjusted Community Rate Proposals for a Southwest Medicare+Choice Organization for Contract Year 2000 (A-09-00-00120)

To

Thomas Scully  
Administrator  
Centers for Medicare and Medicaid Services

Attached are two copies of our final report entitled, "Review of the Administrative Cost Component of the Adjusted Community Rate Proposals for a Southwest Medicare+Choice Organization for Contract Year 2000." The report provides you with the results of our review of a Medicare+Choice contractor (the Plan) in the Southwest.

The Medicare adjusted community rate (ACR) proposal process is designed for Medicare+Choice organizations (M+CO) to present to the Centers for Medicare and Medicaid Services (CMS)<sup>1</sup> their estimate of the funds needed to cover the costs of providing the Medicare package of covered services to any enrolled Medicare beneficiary. The M+CO's anticipated or budgeted funds are calculated to cover medical and administrative costs of the submitted proposals for the contract year (CY) and must be supported by the individual M+CO's operating expenses. Beginning with the Medicare CY 2000, plans were required to use their actual costs in developing their ACR proposals.

The objective of the review was to determine if the administrative costs submitted by the Plan on its ACR proposals were reasonable, necessary, and allocable when compared to the Medicare program's general principle of paying only reasonable costs. The criteria used for our assessment of the administrative costs is not currently applicable to M+COs.

Under the existing ACR methodology, there is no statutory or regulatory authority governing the allowability of costs in the ACR proposal for M+COs, unlike other areas of the Medicare program. For example, regulations covering cost-based managed care organizations provide specific parameters delineating allowable administrative costs for enrollment, marketing, and other administrative and general costs that benefit the total enrollment of a cost-based plan. However, these regulations do not apply to M+CO contracts.

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<sup>1</sup> Formerly known as the Health Care Financing Administration.

Based on our review of (i) the Plan's methodology for allocating administrative costs to Medicare, and (ii) selected administrative costs of about \$52.1 million, we found that \$35.4 million allocated to Medicare included such costs as:

- \$10.1 million of general administrative expenses apportioned to Medicare using premium revenues that would have been disallowed had CMS required M+COs to follow the Medicare cost-based contract criteria. That criteria requires general administrative costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment.
- \$4.0 million in unallocable costs consisting of broker fees, premium taxes, and other costs that would have been disallowed if cost-based principles were applicable to M+COs.
- \$1.0 million of costs relating to such items as bad debt expense, entertainment and alcohol, and other costs that would not have been allowable if the cost-based or cost reimbursement principles (utilized in the fee-for-service program) were in effect for M+COs.
- \$20.3 million in unsupported costs that would have been questioned had Medicare cost-based principles been applicable to M+COs. The costs were primarily for related-party transactions and other costs for which the Plan could not provide adequate supporting documentation.

Under current regulations, the Plan is not prohibited from using revenues as the basis for allocating its indirect costs. Moreover, due to a lack of statutory or regulatory authority governing allowability of costs in the ACR process, the Plan is not prohibited from including items such as broker fees, premium tax, bad debt expense, entertainment, and certain other expenses in its administrative costs. We calculated that the impact of including such costs in CY 2000 resulted in an increase in the administrative costs for all six ACRs by \$99.04<sup>2</sup> per-member per-month (PMPM), or \$12 million (based on actual 1998 total Medicare member months).<sup>3</sup>

Therefore, the effect of including costs that would be unallowable under Medicare cost-based or cost reimbursement principles resulted in overstated administrative costs that

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<sup>2</sup>The Medicare contract included in our review had six ACR proposals. The \$99.04 PMPM cost is a weighted average calculation that was based on those six ACR proposals.

<sup>3</sup>The 1998 total member months were obtained from the Plan's audited annual statement report to the State Insurance Department for year ended December 31, 1998. The total member months reported was used by the Plan for the ACR proposals for CY 2000.

reduced potential excess. The potential excess could have been used for the Medicare beneficiaries by providing additional benefits or reducing premium amounts.

The Plan did not agree with our report. In its response to our draft report, the Plan stated that it did not believe that the process employed in the audit was reasonable and/or comprehensive enough to reach the conclusion that including costs which would be unallowable under Medicare cost-based or cost reimbursement principles resulted in overstated administrative costs that reduced potential savings. Also, the Plan expressed concerns that the audit process employed focused solely on areas that would reduce the Medicare cost allocation under cost-based criteria, and did not include a review of information where the Medicare cost allocation would be increased.

In response to the Plan's concerns, the audit procedures followed were reasonable and comprehensive and included a review of approximately 60 percent of the Plan's total administrative costs. The transactions selected included costs that either benefited both Medicare and non-Medicare, Medicare only, or non-Medicare only lines of business.

Because of the lack of criteria, there are no recommendations. This audit is part of a continuing nationwide review of the ACR process and is being performed at several other M+COs. The results of these reviews will be shared with CMS so that appropriate legislative changes can be considered.

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-09-00-00120 in all correspondence relating to this report.

Attachments

**Department of Health and Human Services**

**OFFICE OF  
INSPECTOR GENERAL**

**REVIEW OF THE ADMINISTRATIVE  
COST COMPONENT OF THE ADJUSTED  
COMMUNITY RATE PROPOSALS FOR A  
SOUTHWEST MEDICARE+CHOICE  
ORGANIZATION FOR  
CONTRACT YEAR 2000**



**JULY 2001  
A-09-00-00120**

**Memorandum**

JUL 19 2001

Date *Michael Mangano*  
From Michael F. Mangano  
Acting Inspector General

Subject Review of the Administrative Cost Component of the Adjusted Community Rate Proposals for a Southwest Medicare+Choice Organization for Contract Year 2000 (A-09-00-00120)

To Thomas Scully  
Administrator  
Centers for Medicare and Medicaid Services

**EXECUTIVE SUMMARY**

This final report presents the results of our review of the administrative cost component of the adjusted community rate (ACR) proposal submitted to the Centers for Medicare and Medicaid Services (CMS)<sup>1</sup> by a Southwest Medicare+Choice contractor (the Plan) for Contract Year (CY) 2000. This review is part of a nationwide review of administrative costs included in the ACR proposals that was requested by CMS.

**BACKGROUND**

The Medicare ACR proposal process is designed for Medicare+Choice organizations (M+CO) to present to CMS their estimate of the funds needed to cover the costs of providing the Medicare package of covered services to any enrolled Medicare beneficiary. The M+CO's anticipated or budgeted funds are calculated to cover medical and administrative costs of the submitted proposals for the contract year and must be supported by the individual M+CO's operating expenses. Beginning with the Medicare CY 2000, plans were required to use their actual costs in developing their ACR proposals.

**OBJECTIVE**

The objective of the review was to determine if the administrative costs submitted by the Plan on its ACR proposals were reasonable, necessary, and allocable when compared to the Medicare program's general principle of paying only reasonable costs. The criteria used for our assessment of the administrative costs is not currently applicable to M+COs. The criteria used for cost health maintenance organizations (HMO) and cost reimbursement as it relates to the fee-for-service program was applied.

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<sup>1</sup> Formerly known as the Health Care Financing Administration.

## SUMMARY OF FINDINGS

Under the existing ACR methodology, there is no statutory or regulatory authority governing the allowability of costs in the ACR proposal for M+COs, unlike other areas of the Medicare program. For example, regulations covering cost HMOs provide specific parameters delineating allowable administrative costs for enrollment, marketing, and other administrative and general costs that benefit the total enrollment. However, these regulations do not apply to M+CO contracts.

Based on our review of the Plan's methodology for allocating administrative costs to Medicare, and selected administrative costs of about \$52.1 million, we found that \$35.4 million allocated to Medicare included such costs as:

- C \$10.1 million of general administrative expenses apportioned to Medicare using premium revenues that would have been disallowed had CMS required M+COs to follow the Medicare cost HMO criteria. That criteria requires general administrative costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment.
- C \$4.0 million in unallocable costs consisting of broker fees, premium taxes, and other costs that would have been disallowed if cost HMO principles were applicable to M+COs.
- C \$1.0 million of costs relating to such items as bad debt expense, entertainment and alcohol, and other costs that would not have been allowable if the cost HMO or cost reimbursement principles (followed in the fee-for-service arena) were in effect for M+COs.
- C \$20.3 million in unsupported costs that would have been questioned had Medicare cost HMO principles been applicable to M+COs. The costs were primarily for related-party transactions and other costs for which the Plan could not provide adequate supporting documentation.

Under current regulations, the Plan is not prohibited from using revenues as the basis for allocating its indirect costs. Moreover, due to a lack of statutory or regulatory authority governing allowability of costs in the ACR process, the Plan is not prohibited from including items such as broker fees, premium tax, bad debt expense, entertainment and certain other expenses in its administrative costs. We calculated that the impact of including such costs in CY 2000 resulted in an increase in the administrative costs for all six ACRs by \$99.04<sup>2</sup> per-member per-month (PMPM), or \$12 million (based on actual 1998 total

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<sup>2</sup> The Medicare contract included in our review had six ACR proposals. The \$99.04 PMPM cost is a weighted average calculation that was based on those six ACR proposals.

Medicare member months).<sup>3</sup> Therefore, the effect of including costs that would otherwise be unallowable under Medicare cost HMO or cost reimbursement principles resulted in overstated administrative costs that reduced potential excess. The potential excess could have been used for the Medicare beneficiaries by providing additional benefits or reducing premium amounts.

Because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations. This audit is part of a continuing nationwide review of the ACR process and is being performed at several other M+COs. We plan to share the results of our reviews with CMS so that appropriate legislative changes can be considered.

In its response to our draft report, the Plan did not believe that the process employed in the audit was reasonable and/or comprehensive enough to reach the conclusion that “including costs that would be unallowable under Medicare cost HMO or cost reimbursement principles resulted in overstated administrative costs that reduced potential excess.” Also, the Plan expressed concerns that the audit focused solely on areas that would reduce the Medicare cost allocation under cost HMO criteria and did not include a review of information where the Medicare cost allocation would be increased. For the full text of the Plan’s comments, see the attached Appendix to this report.

We believe that the audit procedures followed were reasonable and comprehensive and included a review of approximately 60 percent of the Plan’s total administrative costs. The transactions selected included costs that either benefitted both Medicare and non-Medicare, Medicare only, or non-Medicare only lines of business.

## INTRODUCTION

### BACKGROUND

*Under Title XVIII of the Social Security Act, the Medicare program provides health insurance to millions of Americans.*

Under Title XVIII of the Social Security Act, the Medicare program provides health insurance to millions of Americans age 65 and over. The Medicare program also provides health insurance to persons who have permanent kidney failure and certain persons with disabilities. Within the Department of Health and Human Services, the Medicare program is administered by CMS.

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<sup>3</sup>The 1998 total member months were obtained from the Plan’s audited annual statement report to the State Insurance Department for year ended December 31, 1998. The total member months reported was used by the Plan for the ACR proposals for CY 2000.

The Balanced Budget Act of 1997 established Part C of the Medicare program, Medicare+Choice (M+C). The M+C program provides Medicare beneficiaries with a wider range of health plan choices. An ACR proposal is required to be prepared for all the health plan choices. The ACR proposal is designed for a M+CO to present to CMS an estimate of the funds needed by the M+CO to cover the costs of providing the Medicare package of covered services to an enrolled Medicare beneficiary. The estimated funds needed were calculated to cover medical and administrative costs of the Plan for the contract year.

*Beginning with Medicare CY 2000, M+COs were required to develop relative cost ratios based on actual costs.*

Beginning with the ACR proposals for CY 2000, the M+COs were required to develop relative cost ratios based on actual historical costs. For purposes of the administrative component of the ACR, the relative cost ratios were based on the actual administrative costs incurred for Medicare beneficiaries in the base-year to actual administrative costs incurred for non-Medicare enrollees in the same base-year. For CY 2000, the base-year for the Medicare and non-Medicare actual costs was 1998. The ACR is designed to ensure that Medicare beneficiaries are not overcharged for the benefit package offered. If the average Medicare payment was greater than the calculated ACR, the M+COs are required to use this excess to either improve their benefit packages to the Medicare enrollees, reduce each Medicare enrollee's premium, or contribute to a benefit stabilization fund.

Due to a lack of statutory regulations or regulatory authority governing allowability of costs in the ACR process, the M+COs are not prohibited from including administrative costs not traditionally allowed under the Medicare program. For example, regulations covering HMOs that contract with CMS 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 M+CO contracts.

*CMS should pursue legislation concerning allowability and reasonableness of administrative costs for M+CO contracts.*

In a prior Office of Inspector General audit report issued in January 2000,<sup>4</sup> we concluded that costs incurred by nine managed care organizations (MCO) reviewed included \$66.3 million that we would have questioned had the MCOs been required to follow Medicare's general principle of paying only reasonable costs. We recommended that CMS pursue legislation concerning the allowability and reasonableness of administrative costs included in the ACR proposals. While not agreeing

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<sup>4</sup>Review of the Administrative Cost Component of The Adjusted Community Rate Proposal at Nine Medicare Managed Care Organizations for the 1997 Contract Year (A-03-98-00046).

to our recommendations, CMS agreed to use the results of future audits to identify administrative costs that were not related to the M+CO's execution of its contract. This audit is part of a continuing nationwide review of the ACR process and is being performed at several other M+COs.

## **OBJECTIVE, SCOPE, AND METHODOLOGY**

### **Objective**

The objective of our audit was to determine if administrative costs submitted by the Plan on its ACR proposals were reasonable, necessary, and allocable when compared to the Medicare program's general principle of paying only reasonable costs. The criteria used for our assessment of the administrative costs is not currently applicable to M+COs. This included the criteria used for cost HMO and cost reimbursement as it relates to the fee-for-service program.

### **Scope**

Our review was performed in accordance with generally accepted government auditing standards. Since the objective of our audit did not require a full understanding or assessment of the Plan's internal control structure, our review of the internal controls was limited to only those controls considered necessary to meet our objective.

We reviewed the Plan's financial records for the 12-month period ending December 31, 1998, which were used as support for the ACR proposals for CY 2000. The financial records included \$86.8 million in administrative costs, which were allocated to all lines of business based on premium revenues. The percentage of Medicare premiums to total premiums was about 50 percent. As a result, Medicare was allocated approximately \$43.8 million from the administrative cost pool.

The Plan did not maintain separate records for the administrative costs that were allocated to the Medicare and non-Medicare lines of business. Therefore, we judgmentally selected cost items from the general ledger totaling \$52.1 million. Our selection of transactions was based on types of costs that have been found to be problematic under prior ACR audits. Because of the judgmental selection, our results were not projected to the universe of administrative costs submitted by the Plan. In addition to reviewing the selected cost transactions, we also reviewed the allocation methodology used by the Plan for purposes of allocating the administrative costs to Medicare.

## **Methodology**

To accomplish our objective, we:

- < reviewed applicable laws and regulations;
- < discussed with M+CO officials the ACR proposal process and how the administrative costs were derived and allocated to the various lines of business;
- < reconciled the total administrative costs recorded in the Plan's general ledgers to the audited financial statements;
- < judgmentally selected categories of administrative costs for review;
- < reviewed the administrative costs and allocation methodology using Medicare guidelines; and
- < recalculated the administrative costs for the six ACR proposals using the revised base-year costs adjusted for the questionable costs found in our review.

Our field work was performed during July 2000 through February 2001 and included on-site work at the Plan's corporate office.

## **FINDINGS AND CONCLUSION**

The Medicare contract included in our review had six ACR proposals. We found that the administrative cost component on the six ACR proposals for CY 2000 included \$35.4 million in costs that: (i) were in excess of the amount that would have been allocated on the basis of enrollment, (ii) were not allocable to Medicare, (iii) would not be allowable if existing Medicare regulations (either for cost HMOs or in the fee-for-service arena) were applied to M+COs, and (iv) pertained to unsupported related-party transactions and other unsupported costs. Our review of the six ACR proposals submitted for CY 2000 was performed using regulations and guidelines not currently applicable to M+COs.

The inclusion of these costs resulted in an increase in the administrative costs for all six ACR proposals by \$99.04 PMPM, or \$12 million (based on actual 1998 total Medicare member months). The effect of including costs that would be unallowable under Medicare cost HMO or cost reimbursement principles resulted in overstated administrative costs that reduced potential excess. The potential excess could have been used for the Medicare beneficiaries by providing additional benefits or reducing premium amounts. The \$99.04 PMPM cost is the weighted average unit cost and was calculated based on those six ACR proposals.

## **REVIEW OF ALLOCATION METHODOLOGY**

A total of \$10.1 million of administrative costs allocated to Medicare would have been disallowed had CMS required M+COs to follow the cost HMO principles. Under this criteria administrative costs not directly associated with providing medical care must be apportioned on the basis of a ratio of Medicare enrollment to total enrollment. By apportioning the administrative costs not directly associated with providing medical care on the basis of revenue rather than enrollment, the Medicare administrative expenses were increased from \$8.3 million to \$18.4 million.

Beginning with the Medicare CY 2000 for the ACR proposals, M+COs were required to use their actual costs in developing the administrative cost component in the ACR. Most of the Plan's administrative costs were indirect type costs that benefitted both non-Medicare and Medicare enrollees. For allocation of the administrative costs between the Medicare and non-Medicare lines of business, the Plan used premium revenues as the basis for allocation. Because Medicare premiums were significantly higher than non-Medicare premiums, we believe that allocating administrative costs on the basis of premium revenues grossly inflated the Plan's administrative costs needed for Medicare. To illustrate, the Plan allocated approximately 50 percent of its administrative costs to Medicare and 50 percent to its non-Medicare lines of business. However, only about 21 percent of the enrollees were Medicare beneficiaries, whereas 79 percent of the enrollees were members of non-Medicare plans. Consequently, Medicare was allocated about 50 percent of the administrative costs, even though Medicare accounted for only about 21 percent of the enrollees.

The regulations for cost HMO contracts require administrative costs be apportioned between costs not directly associated with providing medical care (general), and costs significantly related to providing medical services. The apportionment for the general costs is to be based on total enrollment. Because M+CO contracts do not require such apportionment, the Plan did not distinguish within its general ledgers the administrative costs that were general type costs and the administrative costs that were significantly related to providing medical services. However, the Plan in its audited annual statement report to the State Insurance Department showed that 93 percent of the administrative costs were general administration expenses and 7 percent were health care related administration expenses. Therefore, we considered that only 93 percent of the administrative costs would be subject to allocation based on enrollment.

The purpose of apportionment is to ensure that the cost of services furnished to Medicare enrollees is not borne by others and that the cost of services furnished to others is not borne by Medicare. Using the principles for cost HMO contracts, we determined that \$10.1 million allocated to Medicare would have been disallowed had CMS required M+COs to follow the cost HMO contract requirements which mandate that general administrative costs be apportioned based on enrollment. The \$10.1 million was based on our review of the

Plan's allocated administrative costs remaining after adjustment for unallocable, questionable, and unsupported costs discussed in our report below.

## **REVIEW OF SELECTED ADMINISTRATIVE COSTS**

Our review of selected administrative cost transactions showed that if Medicare cost HMO or cost reimbursement principles were applicable to M+COs, \$25.3 million of the \$43.8 million in administrative costs allocated to Medicare by the Plan would have been unallocable, not traditionally allowed by Medicare, or not supported.

### **Unallocable Administrative Costs**

We identified administrative costs totaling about \$4.0 million that would not have been allocable to the Medicare program if cost HMO contract principles were applicable to M+COs. According to the cost HMO principles, a cost is allocable if it benefits both the contract and other work, and can be distributed in reasonable proportion to the benefits received. The costs below did not meet this criteria.

**Broker Fees** The Plan contracts with independent contractors who were authorized to sell insurance services for commissions. The Plan's policy is to utilize brokers only in a referral capacity for Medicare sales, with follow-up performed by the Plan's staff. Based on financial information provided by the Plan, broker fees totaling \$2.3 million were applicable only to the non-Medicare lines of business. Therefore, under cost HMO principles, the broker fees of \$2.3 million did not benefit the program and therefore would not be allocable to Medicare.

**Premium Tax Expense** The State levies a tax on direct premiums written covering property or other risks in the State. However, the State excludes premium taxes on payments received by an insurer from the Secretary of Health and Human Services. Consequently, the premium taxes of about \$1.8 million under cost HMO principles would not be allocable to Medicare.

**Other Unallocable Transactions** Using cost HMO contract principles, the following costs would not have been allocable to Medicare. Management fees of \$20,157 were paid to an outside firm to manage workers compensation claims filed by a client of the Plan and were not Medicare related. Legal costs of \$18,897 were incurred as the result of a settlement of a broker's estate. The broker did not provide any Medicare referral services in 1998. Contract costs of \$11,797 resulted from services performed for the parent company by outside parties. Based on documentation provided by the Plan, the services performed were not for the Plan or the Medicare program. Finally, consulting costs of \$5,528 were for various items such as analysis of non-Medicare enrollment records; a

contingency search fee for a position at the parent company; non-Medicare related corporate research; and, a customer satisfaction survey associated with one of the non-Medicare lines of business.

**Non-Medicare Offset** Our review of selected administrative cost transactions and supporting documentation, showed that costs totaling \$114,690 that benefitted only the Medicare program were allocated to the non-Medicare lines of business. We offset these Medicare only costs against the non-Medicare only costs discussed above.

### **Costs Not Traditionally Allowed By Medicare**

Administrative costs totaling about \$1.0 million would not have been considered reasonable using Medicare's principle of paying only reasonable costs. We used the cost HMO or cost reimbursement criteria for assessing these costs; however, the Plan was not required to follow these principles because these standards do not apply to M+CO contracts. The assessment was performed to determine what costs would not have been allowed if the Plan was required to follow such principles. The costs we found that are not traditionally allowed by Medicare are described as follows.

**Bad Debt Expense** Bad debt expense for uncollectible accounts totaling \$838,988 was allocated to Medicare. Bad debt expense is allowable under Medicare cost HMO principles only if the bad debt expenses are attributable to Medicare deductible and coinsurance amounts for which the Medicare enrollee is liable. Based on documentation provided to us by the Plan, the bad debt expense was not attributable to such Medicare costs. Therefore, the bad debt expense allocated to Medicare would be unallowable under cost HMO principles that currently are not applicable to M+COs.

**Meals/Entertainment Expenses** Costs associated with entertainment, food, and alcohol totaling \$115,350 were in the administrative costs for the ACR proposals. We found:

- C \$52,496 for suite rentals and tickets for basketball games, football games, rodeos, hockey games, and NASCAR races. In addition, tickets were purchased for various concerts.
- C \$36,137 for golf club memberships and golf fees at various resorts and hotels.
- C \$24,004 for food and miscellaneous costs at golf clubs, resorts, hotels, and tailgate parties.
- C \$2,713 for alcoholic beverages at employee parties and sales conferences.

According to cost reimbursement principles, which are not applicable to M+COs, costs of amusement, diversions, social activities, and any directly related costs, such as tickets to shows or sporting events, meals, lodging, rentals, transportation, and gratuities are unallowable. Costs of alcoholic beverages are also unallowable.

**Promotion, Advertising, and Public Relations** Administrative costs totaling \$15,742 would not have been allowable under Medicare cost reimbursement principles. We found promotion, advertising, and public relations costs totaling \$13,122 was for tote bags, souvenirs, and Christmas gift baskets for clients and brokers. Allowable public relations and promotion costs do not include costs of promotional material, handouts, or other mementos.

In addition, costs totaling \$2,620 was incurred for sponsoring live talk television shows. We were informed that the National Highway Traffic Safety Administration reimbursed the Plan for these costs. The Plan did not provide us with a corresponding offset for the promotion expenses that were reimbursed.

**Other Selected Transactions** Other expenses allocated to Medicare related to various types of costs, which are not traditionally allowed using cost reimbursement principles, that are not applicable to M+COs. These costs consisted of lobbying, contributions, and travel costs associated with unallowable entertainment expenses.

We found lobbying expenses totaling \$10,583 was for contributions to several political campaigns. The cost reimbursement principles do not allow for costs associated with lobbying and political activity.

Contributions totaling \$4,006 were to individuals, a baseball club, and a scholarship golf tournament. The cost reimbursement principles prohibit such costs. Specifically, contributions or donations, including cash, property, and services, regardless of recipient, would be unallowable. The costs of sponsoring special events when the purpose of the event is other than disseminating technical information would be unallowable.

Travel costs totaling \$1,708 was for hotel lodging charges at golf resorts, and banquets at a hotel casino. As these costs are associated with unallowable entertainment expenses, the corresponding travel costs would also be unallowable.

### **Unsupported Costs**

The Plan was unable to provide support for \$20.3 million of administrative costs. While these expenses may have been allowable Medicare expenses, the Plan could not provide the supporting documentation that was deemed necessary to fully evaluate the costs.

Accordingly, no determination could be made on the allowability of these costs. The costs for which the Plan did not have adequate supporting documentation are described in the following categories.

**Related-party Transactions** The Plan included costs for related-party management fees totaling about \$20.3 million. The management fees were a result of a negotiated agreement between the Plan and the parent corporation. The agreement provides for services to be performed by the parent such as: budgeting, purchasing, personnel, payroll, office space, actuarial services, underwriting, consulting, and electronic data processing. The management fee charged to the Plan was a computation that was based on the Plans revenues and not on the related-party's actual costs. While related-party costs are allowable under Medicare fee-for-service, Medicare limits the provider's reimbursement to the related-party's actual costs. Moreover, Medicare requires cost HMOs to allocate allowable costs of a separate entity or department that performs administrative services in reasonable proportion to the benefits received. Since the management fee is a calculation based on the Plan's revenues and not on actual costs, no determination could be made as to the allowability of the costs.

**Other Unsupported Transactions** The Plan included other costs totaling \$28,416 for which it was unable to provide adequate supporting documentation. The costs were for such categories as: consulting services, conferences, travel, promotion, director fees, education, and lobbying. Due to the lack of supporting documentation, we were unable to determine the allowability of these costs.

## **IMPACT ON THE ACR PROPOSALS**

Our review of the ACR proposals for CY 2000 showed that as much as \$35.4 million would have been unallowable for allocation to Medicare had the Plan been required to follow Medicare's general principle of paying only reasonable costs. Administrative costs for the ACR proposals are determined using a "relative cost ratio" based on actual administrative costs incurred for Medicare beneficiaries in a base-year relative to actual administrative costs incurred for non-Medicare enrollees in the same base-year. For the CY 2000, the base-year was 1998.

The "relative cost ratio" is applied to estimated non-Medicare administrative costs (the initial rate) for the year being reported upon to arrive at the Medicare administrative costs for CY 2000. As a result of these \$35.4 million base-year costs, we calculated that the impact of including such costs in CY 2000 resulted in an increase in the administrative rate by \$99.04 PMPM, or \$12 million (based on actual 1998 member months). Because the Medicare contract included in our review had six ACR proposals, the \$99.04 PMPM cost is the calculated weighted average unit cost based on the six ACR proposals. The effect of including costs that would be questionable under Medicare cost HMO or cost reimbursement principles resulted in overstated administrative costs that reduced potential excess.

The potential excess could have been used for the Medicare beneficiaries by providing additional benefits or reducing premium amounts.

## **CONCLUSION**

Using criteria that are currently not applicable to M+COs, our review found administrative costs allocated to the Medicare program that were unallocable, not traditionally allowed, or unsupported. The inclusion of such costs affects the computation of potential excess from the Medicare payment amounts and adversely impacts the excess amount available to provide Medicare beneficiaries with additional benefits or reduction of premium amounts. Unlike other areas of the Medicare program, we recognize that presently there is no statutory or regulatory authority governing the allowability of costs in the ACR process. For example, regulations covering providers that contract with CMS 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 M+CO contracts. Thus, no recommendations are addressed to the Plan. Instead, we are sharing the results of this review with CMS so that appropriate legislative changes can be considered.

## **PLAN'S COMMENTS**

In its response, the Plan expressed several concerns about our report. These concerns are shown below.

- < The Plan disagreed that there is a lack of criteria for inclusion of administrative costs on the ACR proposal. They stated that there are criteria under the current CMS guidelines, which were not applied in this audit.
- < The Plan did not believe that the process used in the audit was reasonable and/or comprehensive enough to reach the conclusion that “including costs that would be unallowable under Medicare cost HMO or cost reimbursement principles resulted in overstated administrative costs that reduced potential excess.” The audit focused solely on areas that would reduce the Medicare cost allocation under cost HMO criteria and did not include a review of information where the cost allocation would be increased, although such information was available and offered. Further, the auditors declined a review of material from an affiliate in order to obtain such information.
- < The Plan stated that the conclusions reached, with respect to those costs deemed by the auditors to be unsupported costs, implicitly assume that the Plan would not modify its documentation requirements to support the administrative expenses. They further stated that, if the Plan were subject to standards similar to those required for cost HMO reimbursement, it is only reasonable to assume that the Plan would modify its documentation procedures to comply. They also commented that the

conclusions reached made no effort to reasonably estimate the impact of such a change on the Plan's procedures and the resulting increase in supportable costs.

The full text of the Plan's comments has been included as an Appendix to this report.

## **OIG'S RESPONSE**

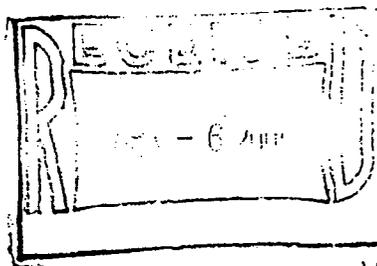
Contrary to the Plan's assertion that there is criteria governing administrative costs in the ACR proposal, there is no statutory or regulatory authority governing administrative costs in the ACR proposal for M+COs. Neither the CMS instructions for completing the ACR proposal, nor the CMS contract with the Plan provide guidelines for excluding administrative costs not traditionally allowed under the Medicare program.

Although the Plan expressed concerns about the audit process and conclusions, the procedures we followed were reasonable and comprehensive and included a review of approximately 60 percent of the Plan's total administrative costs. The transactions selected included costs that either benefitted both Medicare and non-Medicare, Medicare only, or non-Medicare only lines of business. The transactions reviewed, which benefitted only the Medicare program, were offset against the non-Medicare only costs. In addition, our review of the management fee showed that the related third party did not allocate or directly charge its actual costs to the Plan. Therefore, a review of the related-party material would not have enabled us to identify the related-party's costs applicable to the Plan. The conclusions reached were based on assessment of the administrative costs used in the ACR proposals with criteria not currently applicable to M+COs. While we can understand the Plan's concerns with this approach, we consider this assessment useful in determining if appropriate legislative changes are necessary.

With respect to the Plan's position regarding possible changes in the company's procedures relative to the unsupported costs, the report does not imply that the company would not modify its procedures and documentation requirements in the future, especially if required to do so. The audit objective was not to estimate the results if certain procedures or changes were implemented by the Plan. Instead, our objective was to review the 1998 administrative costs allocated to Medicare under the Plan's established procedures applicable to that period of time.

## **APPENDIX**

April 4, 2001



Ms. Lori A. Ahlstrand  
Regional Inspector General  
for Audit Services  
DEPARTMENT OF HEALTH & HUMAN SERVICES  
Office of Inspector General  
Region IX  
Office of Audit Services  
50 United Nations Plaza  
San Francisco, CA 94102

VIA FACSIMILE (415) 437-8372  
Original to follow via express mail

REFERENCE:

***CY 2000 ACRP Administrative Cost Review  
Common Identification Number A-09-00-00120***

Dear Ms. Ahlstrand:

We are in receipt of the draft report titled "Review of the Administrative Cost Component of the Adjusted Community Rate Proposals for a Southwest Risk-Based Managed Care Organization for Contract Year 2000."

We hosted two auditors from your office for a period of approximately three months while they undertook the fieldwork portion of this audit. We understand that your goal in conducting these types of audits is to establish the bases for recommendations to the Health Care Financing Administration (HCFA) for changes related to the adjusted community rate process.

With respect to the comment in your cover letter about a "...lack of criteria for inclusion of administrative costs on the adjusted community rate proposal," we disagree. There are criteria under the current HCFA guidelines. Unfortunately, they were not applied in this audit.

We don't believe the process employed in this audit was reasonable and/or comprehensive enough to reach the conclusion that "...including costs that would be unallowable under Medicare cost-based or cost reimbursement principles resulted in overstated administrative costs that reduced potential savings. The potential savings could have been used for the Medicare beneficiaries by providing additional benefits or reducing premium amounts." The audit process employed focused solely on areas that would reduce the Medicare cost allocation under cost-based criteria and did not include a review of information where the Medicare cost allocation would be increased, although such information was available and offered. In fact, where questions were asked by the auditors that would require a review of material from an affiliate in order to obtain the information, the auditors declined such a review of clearly relevant information as being outside the scope of the review.

Ms. Lori A. Ahlstrand  
HHS OIG/Audit Services  
April 4, 2001  
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In order to maintain confidentiality, we appreciate that there will not be any direct identification or references to our organization in the report. It would not be difficult, however, for a competent researcher to ascertain which health plan this report refers to should they elect to undertake such an effort. For this reason, we respectfully request that all references to specific dollar amounts be referenced as rounded amounts, that the footnoted reference on page 2 to the plan be removed or re-phrased and that the tables containing specific line item amounts be deleted; i.e., Unallocable Administrative Costs (page 7), Costs Not Traditionally Allowed by Medicare (page 9), Unsupported Costs (page 11).

Finally, with respect to those costs deemed by the auditors to be unsupported costs, the conclusions reached implicitly assume that the company would not modify its documentation requirements to support the administrative expenses. If the company were subject to standards similar to those required for cost-based reimbursement, it is only reasonable to assume that the company would modify its documentation procedures to comply. The conclusions reached make no effort to reasonably estimate the impact of such a change in company procedures and the resulting increase in supportable costs.

We appreciate the opportunity to review and comment upon the report prior to its finalization and submission to HCFA.

Sincerely,

cc: