

**Memorandum**

Date **DEC 14 1992**

From Bryan B. Mitchell *Bryan Mitchell*
Principal Deputy Inspector General

Subject Assessment of the Usage of Bid Proposal Audits of
Utilization and Quality Control Peer Review Organizations
(A-14-91-00343)

To William Toby, Jr.
Acting Administrator
Health Care Financing Administration

Attached is the final audit report on the results of our review of the usage made by the Health Care Financing Administration (HCFA) of the Office of Inspector General's (OIG) bid proposal audits of peer review organizations (PRO). The objectives of our review were to determine (1) the cost-effectiveness of performing the 12 PRO bid proposal audits completed during Fiscal Year (FY) 1990 and (2) the adequacy of HCFA's efforts to reduce the occurrence of unsupported costs in subsequent bid proposals.

We found that the OIG audits of PRO bid proposals completed during FY 1990 resulted in a savings to the Medicare PRO program of over \$33 million. This represents an extremely favorable return of \$83 to \$1 when compared with the cost of performing those audits. We also determined that HCFA: (1) could improve on its efforts to educate PROs about unsupported costs in their bid proposals and (2) had not taken a systematic approach to ensure that PROs take appropriate actions in response to procedural improvements called for in PRO bid proposal audits.

Since our review showed that these audits are extremely cost-effective in terms of program savings as compared with the cost of performing the audits, we plan to work with HCFA in the continuation of our involvement with future PRO audits. We do, however, recommend that HCFA include, in future requests for proposals for PRO contract awards, language to alert PROs of the types of unsupported costs found in the OIG's bid proposal audits. We also recommend that HCFA monitor PROs subsequently contracted to ensure that corrective actions are taken as a result of procedural improvements called for in PRO bid proposal audits.

Page 2 - William Toby, Jr.

The HCFA, in response to our draft report, concurred with all our recommendations but did have some additional comments which we have addressed. The complete text of HCFA's response is included as the Appendix to the report.

Please advise us, within 60 days, on actions taken or planned on our recommendations. 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. Copies of this report are being sent to other interested Department officials.

Attachment

Department of Health and Human Services

OFFICE OF
INSPECTOR GENERAL

ASSESSMENT OF THE
USAGE OF BID PROPOSAL AUDITS OF UTILIZATION
AND QUALITY CONTROL PEER REVIEW
ORGANIZATIONS



DECEMBER 1992 A-14-91-00343

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Subject Assessment of the Usage of Bid Proposal Audits of
Utilization and Quality Control Peer Review Organizations
(A-14-91-00343)

To William Toby, Jr.
Acting Administrator
Health Care Financing Administration

This final audit report provides you with the results of our review of the Health Care Financing Administration's (HCFA) usage of bid proposal audits of peer review organizations (PRO) performed by the Office of Inspector General (OIG). The objectives of this limited scope audit were to determine (1) the cost-effectiveness of the 12 bid proposal audits of PROs which were completed during Fiscal Year (FY) 1990 and (2) the adequacy of HCFA's efforts to reduce the occurrences of unsupported costs in subsequent bid proposals.

Our review determined that the OIG's 12 PRO bid proposal audits completed during FY 1990 resulted in a savings to the Medicare program of over \$33 million. This was nearly 17 percent of the total costs proposed. In terms of cost-effectiveness, the \$33 million in savings represented an \$83 to \$1 return when compared with the cost of performing these audits. We found, however, that HCFA did not have a comprehensive program to reduce the occurrences of unsupported costs in future PRO bid proposals. We further found that HCFA has not taken a systematic approach to ensure that PROs take appropriate actions in response to procedural deficiencies noted in OIG's PRO bid proposal audits. We, therefore, recommend 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 recommend that HCFA monitor PROs subsequently contracted to ensure that corrective actions are taken as a result of procedural improvements called for in these preaward audits.

The HCFA, in response to our draft report, concurred with all our recommendations but did have some additional comments which we have addressed at the conclusion of this report. The complete text of HCFA's response is included as the Appendix.

Background

The Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248, commonly referred to as TEFRA) requires that the Secretary of the Department of Health and Human Services (HHS) enter into contracts with PROs to review the quality, necessity, reasonableness, and appropriateness of health care provided to Medicare beneficiaries. The initial PRO contracts were negotiated and awarded in 1984. 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 to HCFA's Division of Health Standards Contracts (DHSC). Among other things, 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.

Currently, HCFA has entered into 53 contracts with PROs nationwide. These 3-year contracts: (1) include objectives to be achieved during the contract period; (2) define the structure, scope, and process of Medicare review performed by the PROs; (3) define review of the quality, medical necessity, reasonableness, and appropriateness of inpatient acute care services reimbursable under Medicare; and (4) specify the PRO's obligation to assist with reviews related to other Medicare activities. Since the first contracts were signed in 1984, the Medicare program has relied upon the PROs to be the primary safeguard against inadequate medical treatment for individual beneficiaries. The original and subsequent two PRO contract rounds consisted of fixed-price or modified fixed-price agreements. The current round of planned PRO contracts, round IV, will consist of cost-reimbursement contracts with a negotiated not-to-exceed cap.

The PRO contracts which HCFA enters into have a clause that states, in general terms, if a PRO is performing at an acceptable level but HCFA wants to open the award to other prospective bidders, HCFA must notify the existing PRO, in writing, at least 90 days prior to the contract expiration date of its intention not to automatically renew the

existing contract. Historically, most PROs have at least been able to meet HCFA's minimum standards of acceptable performance for the various categories for which a PRO is graded. As a result, the overwhelming majority of PRO contracts are renewed without competition. During the last contracting period, only 9 out of 53 PRO contracts were open to competition. Of the nine PROs who had to compete for the contract renewal, five were awarded the subsequent contract. Only four PROs failed to have their contracts renewed.

At HCFA's request, the OIG Office of Audit Services (OAS) has conducted bid proposal audits of PRO business proposals and furnished the results to HCFA for its use in negotiating contracts. These audits have provided DHSC with sufficient data to effectively negotiate procurement contracts. The objectives of these preaward audits were 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. Since the PRO contracting methodology is transitioning from fixed-price to cost-reimbursement, an even greater reliance must be placed on a PRO's accounting system and internal controls to accurately control, identify, measure, and report the cost of performing the tasks called for in PRO contracts.

Scope of Review

The objectives of this limited scope audit were to determine: (1) the cost-effectiveness of the OIG's 12 bid proposal audits completed during FY 1990 and (2) the adequacy of HCFA's efforts to reduce the occurrences of unsupported costs in subsequent bid proposals. The 12 PRO audits completed during FY 1990 were those for: Alabama, Connecticut, Hawaii, Iowa, Massachusetts, North Carolina, North Dakota, Puerto Rico, Texas, the Virgin Islands, Virginia, and Wisconsin. Our field work was performed during FY 1991 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.

Results of Review

To determine the overall cost-effectiveness of the 12 PRO bid proposal audits completed during FY 1990, we computed the program savings resulting from those audits as well as the costs of performing the audits. To determine program savings, we reviewed each bid proposal audit report to ascertain the contract amount proposed by the PRO and the total amount the OIG considered unsupported. We then determined the actual award amount by examining the approved award documents (Standard Form 26) filed with the contracts. Basically, program savings were calculated as the difference between the amount of the proposal and the contract award amount limited to the amounts we considered unsupported. To arrive at the OAS cost of performing the 12 PRO bid proposal audits, we obtained the OAS staff hours expended for each of the audits from the OIG's Audit Information Management System. We then applied the official OAS billing rate for FY 1990 to the total OAS staff hours expended on all 12 audits. The OAS billing rate includes salaries, fringe benefits, travel, and overhead and is the rate used by OAS to bill for audit services provided to agencies outside HHS.

Each Audit Dollar Spent Resulted in \$83 of Program Savings

Our review showed that program savings resulting from the 12 OIG bid proposal audits completed in FY 1990 amounted to over \$33 million or nearly 17 percent of the \$196 million proposed by the PROs. The cost to the OAS of performing these 12 bid proposal audits was approximately \$400,000. A comparison of the program savings of \$33 million with the total costs to perform the audits of \$400,000 yields a very favorable benefit/cost ratio of \$83 to \$1. This means that every dollar expended by the OAS to perform PRO preaward audits resulted in savings to the Federal Government of \$83.

Our determination of the adequacy of HCFA's efforts to reduce the occurrences of unsupported costs in subsequent PRO bid proposals was based on a review of past negotiations, a review of current RFPs for contract awards and discussions with various HCFA contracting officials. In performing this segment of the audit, we categorized our past financial findings to determine which types of proposed costs represented the largest percentage of the amounts we considered unsupported. Our work centered on

the reports' summary schedules which show the categories and amounts of proposed costs that we either questioned as unallowable/unreasonable, or we set aside for adjudication by HCFA (the awarding agency). The total of questioned and set-aside costs represented the amount we considered unsupported.

Salaries and Fringe Benefits Were Consistently Unsupported by Prospective PROs

Our review indicated that salaries and fringe benefits, as single cost categories, consistently accounted for the largest portion of unsupported costs. On average,

salaries and fringe benefits represented nearly 48 percent of the total costs we considered unsupported. Specifically, we found that the PRO bid proposals:

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

Actions Taken by HCFA Were Inadequate to Avoid Future Unsupported Cost Submissions

Given the historical data, we evaluated HCFA's procedures to reduce the incidence of these types of findings in future proposals. We found that HCFA discusses these items

during current negotiations. The HCFA's procedures, however, with respect to future contracts could be improved. The HCFA has not used the RFPs to inform offerors of these historical findings. The RFPs for current PRO awards do not contain any language to alert offerors of salary and fringe benefit problem areas found in previous PRO audits.

HCFA Does Not Follow Up on
Noted PRO Procedural
Deficiencies

An analysis of prior bid proposal audit reports issued for all PROs indicated that 17 of the 53 reports examined showed procedural weaknesses

involving PRO accounting systems or internal controls. All 17 of the PROs that were cited for procedural weaknesses were awarded renewal contracts. In some cases we suggested improvements to alleviate the noted deficiency. Some of these included:

- o the establishment of written accounting procedures,
- o separation of duties involving financial transactions,
- o repayment of loans made by management personnel,
- o establishment of controls to prevent unauthorized expenditures, and
- o establishment of competitive procurement practices.

We asked HCFA contracting officials both in writing and verbally if: (1) HCFA had notified the applicable PRO of the procedural deficiencies noted; (2) corrective action had been taken by the PRO; and (3) HCFA had monitored corrective actions. The HCFA contracting officials did not provide any written response to our inquiry but, in discussions, they indicated that they did not have any knowledge of actions taken relative to the procedural deficiencies noted since HCFA does not have systematic follow-up procedures.

Conclusions and Recommendations

Our review showed that the OIG preaward audits of PROs were extremely cost-effective in terms of program savings as compared with the cost of performing the audits. The benefit/cost ratio for the performance of the audits was \$83 to \$1.

Our review also showed that PROs are consistently overstating salary and fringe benefit costs in their bid proposals and that HCFA could improve on its efforts to educate PROs of such deficiencies. Therefore, we recommend that HCFA include in 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 to take particular care in the development of these costs in the business proposal responding to the RFP. This statement should reference the following specific items: excessive inflation rates, salaries and fringe benefits for unfilled or unnecessary positions, and excessive salaries and fringe benefits for top management.

Finally, we found that HCFA had not monitored PROs to determine if corrective actions were taken by them as a result of procedural deficiencies noted in our bid proposal audit reports. These procedural deficiencies involved PRO accounting systems and internal controls. Since the PRO contracting methodology is transitioning from fixed-price to cost-reimbursement, HCFA must depend heavily on a PRO's ability to accurately control, identify, and report the costs associated with Medicare's review activities. Therefore, we recommend that HCFA determine if our suggested procedural improvements made in prior PRO audit reports were implemented and, if appropriate, address the need to pursue any unimplemented suggestions. We also recommend that HCFA institute procedures to effectively monitor PRO responses to accounting system/internal control deficiencies noted in current and future PRO bid proposal audit reports.

HCFA Comments

The HCFA officials concurred with all our recommendations. They agreed that it is appropriate to include a statement addressing OIG audit monetary findings in future RFPs. Concerning our suggested procedural improvements, HCFA will require PROs to correct any deficiencies noted in OIG preaward audit reports and will, in the future, monitor PRO responses to noted accounting system/internal control deficiencies. The HCFA is currently developing an automated system which should facilitate the identification of needed PRO corrective actions.

As additional comments to their response, HCFA clarified the non-renewal process for incumbent PROs. They also agreed that OIG preaward audits are clearly cost-effective. The following items were also noted:

- o The OIG's preaward audits are only one of many tools used in negotiating a PRO contract, thus, the \$83 to \$1 savings ratio for PRO audits is unreasonable.

- o There is a wide disparity in preaward audits' quality, scope, and timeliness, however, audit reports are used in negotiations when available.
- o A cost accounting system for PRO cost contracts has been implemented which will provide needed controls.

OIG Response

We are pleased that HCFA has concurred with all our recommendations and believe that the changes made will promote economies and efficiencies in the PRO program. We also appreciate HCFA's clarification of the non-renewal process for incumbent PROs. Concerning HCFA's other comments:

- o The OIG acknowledges that there are other factors, besides our audit reports, which enter into the determination of a fair and reasonable price for a PRO contract. Our report does not intend to demean HCFA's efforts in the negotiation process. However, our calculation of the \$83 to \$1 ratio does limit OIG claimed savings to the total amount we considered unsupported (questioned costs plus costs set aside for adjudication). No additional savings are claimed if HCFA negotiates a PRO contract for an amount less than we considered reasonable. We believe that using the amount OIG considered reasonable as a base line for savings calculation is an appropriate methodology.
- o All OIG PRO preaward audits are performed in accordance with generally accepted government auditing standards with a scope sufficient to adhere to those standards. However, we do not dispute that some audit reports are more useful than others. Concerning the timeliness factor, the most critical element in being timely revolves around when we receive the business proposal for review from HCFA as compared to when HCFA needs the audit results. In the past, this time frame has often been very short which has necessitated utilizing OIG audit resources to the fullest extent. Also, prior to the issuance of a final audit report, OIG auditors routinely transmit working draft reports and provide verbal reports of

findings to HCFA's contract specialists. This is done prior to contract negotiations so as not to render our final reports ineffective. Currently, OIG and HCFA staff are working jointly to reduce, as much as possible, the time constraints associated with PRO audits. We appreciate HCFA's efforts in this area.

- o We are aware of the cost accounting system and related business proposal format which PROs are now utilizing. We acknowledge that HCFA has taken steps in the right direction by their implementation.

APPENDIX



DEPARTMENT OF HEALTH & HUMAN SERVICES

Memorandum

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From

William Toby, Jr.
William Toby, Jr.
Acting Administrator

Subject

Office of Inspector General (OIG) Draft Report: "Assessment of the Usage of Bid Proposal Audits of Utilization and Quality Control Peer Review Organizations," A-14-91-00343

To

Bryan B. Mitchell
Principal Deputy Inspector General

We have reviewed the subject draft report which contains the results of OIG's review of the Health Care Financing Administration's (HCFA's) use of the OIG bid proposal audits of peer review organizations (PROs). OIG conducted the audit to determine the cost-effectiveness of performing the audits and the adequacy of HCFA's efforts to reduce the recurrence of unsupported costs in subsequent bid proposals.

OIG found that the savings resulting from the OIG audits of PRO bid proposals completed during fiscal year 1990 were over \$33 million. The rate of return from those audits was 83 to 1. OIG also found that HCFA could improve its efforts to educate PROs about unsupported costs in their bid proposals, and that HCFA had not taken a systematic approach to ensure that PROs take appropriate actions in response to procedural improvements called for in PRO bid proposals.

OIG recommends the following actions be taken by HCFA:

- o HCFA should include in future requests for proposals (RFPs) for PRO contract awards a statement indicating that OIG reports show significant problems with amounts proposed for salaries and fringe benefits and to take particular care in the development of these costs in the business proposal responding to the RFP. This statement should reference the following specific items: excessive inflation rates, salaries and fringe benefits for unfilled or unnecessary positions, and excessive salaries and fringe benefits for top management.
- o HCFA should determine if OIG's suggested procedural improvements made in prior PRO audit reports were implemented and, if appropriate, address the need to pursue any unimplemented suggestions.
- o HCFA should also institute procedures to effectively monitor PRO responses to accounting system/internal control deficiencies noted in current and future PRO bid proposal audit reports.

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HCFA concurs with the recommendations. Our specific comments are attached for your consideration.

Thank you for the opportunity to review and comment on this draft report. Please advise us whether you agree with our position on the report's recommendations at your earliest convenience.

Attachment

Comments of the Health Care Financing Administration (HCFA)
on the Office of Inspector General (OIG) Draft Report -
"Assessment of the Usage of Bid Proposal Audits
of Utilization and Quality Control Peer Review
Organizations," A-14-91-00343

Recommendation 1

HCFA should include in future requests for proposals (RFPs) for peer review organization (PRO) contract awards a statement indicating that OIG audit reports show significant problems with amounts proposed for salaries and fringe benefits and to take particular care in the development of these costs in the business proposal responding to the RFP.

HCFA Response

HCFA concurs with the recommendation. We agree that it is appropriate to include this statement in future RFPs for PRO contract awards.

Recommendation 2

HCFA should determine if OIG's suggested procedural improvements made in prior PRO audit reports were implemented and, if appropriate, address the need to pursue any unimplemented suggestions.

HCFA Response

HCFA concurs with the recommendation. HCFA staff will review the audit report findings for compliance prior to negotiating contracts or major contract modifications with the PROs and require the PROs to correct any deficiencies. Also, during the term of the contract, if OIG identifies a situation where the PRO is out of compliance with its contract, the PRO will be required to certify that all deficiencies have been corrected. If the deficiencies have not been corrected, HCFA will issue a corrective action plan to the PROs stipulating a date by which the plan must be completed. After HCFA is notified that the procedural deficiency has been corrected, a representative of HCFA will verify that the corrections have been made.

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Recommendation 3

HCFA should institute procedures to effectively monitor PRO responses to accounting system/internal control deficiencies noted in current and future PRO bid proposal audit reports.

HCFA Response

HCFA concurs with the recommendation. We will develop procedures to monitor PRO responses to accounting system/internal control deficiencies noted in current and future PRO bid proposal audit reports. However, since this report was completed, all PROs have implemented a uniform cost accounting system which is expected to resolve the problems noted in the report.

Also, HCFA is currently developing an automated system for analyzing PRO cost data and for identifying aberrant and/or inconsistent data. This system is expected to enable HCFA to identify more easily situations in which corrective actions are needed.

Additional Comments

1. In the background section, the report indicates that PRO contracts contain a clause that states "if a PRO is performing at an acceptable level but HCFA wants to open the award to other prospective bidders, HCFA must notify the existing PRO, in writing, at least 90 days prior to the contract expiration date of its intention not to automatically renew the existing contract."

In fact, HCFA will automatically renew a contract with a PRO that is performing acceptably, assuming we can reach agreement on price. However, we can award a competitive contract if a PRO is not performing acceptably, upon 90 days notice to the current PRO.

2. We agree that OIG preaward audits of PRO business proposals are clearly cost-effective. However, we believe the \$83 to \$1 savings ratio is significantly overstated. To compute this figure, OIG considered the difference between the original PRO proposal and the final negotiated award as savings attributable to the audit findings, not to exceed the amount of questioned costs and adjudicated costs in the OIG report. OIG's preaward audit is only one of many tools that a contract specialist utilizes to determine a fair and reasonable price for a PRO contract. Therefore, without analyzing OIG's or the contract specialists' data, it is difficult to determine if the savings quoted in the OIG audit all should be attributed to the preaward audits.

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Furthermore, HCFA usually awards a contract that is significantly less costly than the PRO's original proposal. Thus, to ascribe nearly all reductions to the OIG audit findings is unreasonable. Instead, we suggest that the OIG attribute savings to those costs the auditors find to be unsupportable.

3. The report states that the preaward audits of PRO business proposals ". . . . have provided (HCFA's Contracts Office) with sufficient data to effectively negotiate procurement contracts." Certainly these audits, when available, can be extremely helpful. However, this statement does not recognize the wide disparity in the audits' quality, scope, or timeliness. For example, an audit containing a large number of set-asides, or not received until after negotiations begin, is of limited use in contract negotiations. In fact, HCFA's contract staff almost always prepare their pre-negotiation position without benefit of the audit report, relying on their own analysis and the recommendations of program staff in the central and regional offices. Audit reports are used in negotiations when the report is received timely. It would be helpful to receive those reports prior to contract negotiations.
4. On page 7, the report states that deficiencies involving PRO accounting systems are particularly significant because the new cost reimbursement contracts require HCFA to depend heavily on a PRO's ability to accurately control, identify and report the costs of review activities. We agree that there is a need for accurate and timely cost data from PROs under cost reimbursement. We have implemented a sophisticated cost accounting system for PRO cost contracts which will provide these controls, and a related business proposal format that will facilitate the comparison of proposed and historical costs. We believe the report should note these facts.