

**Memorandum**

Date

MAY 11 2007  
Thomas D. Roslewicz

From

Deputy Inspector General  
for Audit Services

Subject

To

Review of the Administrative Cost Component of the Adjusted Community Rate Proposal  
for a Northwest Medicare+Choice Organization for Contract Year 2000 (A-10-00-00013)Neil Donovan  
Director, Audit Liaison Staff  
Health Care Financing Administration

Attached are two copies of our final report entitled, "Review of the Administrative Cost Component of the Adjusted Community Rate Proposal for a Northwest Medicare+Choice Organization for Contract Year 2000."

We suggest that you share this report with the Health Care Financing Administration (HCFA) components involved in the Medicare managed care organization operations, particularly the Center for Health Plans and Policy. The report presents the results of our review of the administrative cost component of the adjusted community rate (ACR) proposal submitted to HCFA by a Northwest Medicare+Choice organization (the Plan) for contract year (CY) 2000. The objective of our review 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 principle of paying only reasonable costs. This review is part of a nationwide review of administrative costs included in the ACR proposals.

In an Office of Inspector General (OIG) audit report issued in January 2000, we identified \$66.3 million of administrative costs that were included in the ACR proposals submitted by nine managed care organizations (MCO)<sup>1</sup>. These administrative costs would have been unallowable had the MCOs been required to follow Medicare's general principle of paying only reasonable costs. We recommended that HCFA pursue legislation concerning MCOs' administrative costs which would require MCOs to follow Medicare's general principle of paying only reasonable costs. In response to our draft report, HCFA did not concur with the recommendation. The HCFA noted that it had recently revised the ACR methodology and that the new procedures will be reviewed to ensure the effectiveness of reducing the administrative burdens on the MCO.

---

<sup>1</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)

Based on the results of our audits at the nine MCOs, HCFA requested that OIG examine other MCOs to determine if administrative costs, that would be deemed unallowable under Medicare's reasonable cost principles, were included in the computation of the ACR proposals under the revised format. This review is in response to HCFA's request.

The Medicare ACR process is designed for Medicare+Choice organizations (M+CO) to present to HCFA their estimates of the funds needed to cover the costs of providing the Medicare package of covered services to enrolled Medicare beneficiaries. An M+CO estimate includes medical and administrative costs for the upcoming year and must be supported by its operating experiences related to utilization and expenses. Beginning in CY 2000, M+COs were required to use their actual Medicare costs (base year) in developing their ACRs. For CY 2000, the base year was 1998.

The Plan's CY 2000 ACR proposal contained 1998 base year costs of \$5.2 million of Medicare administrative costs. Based on our review of \$2.7 million of these costs, we found:

- \$132,471 of entertainment, travel, charitable contributions, and other costs that would not have been allowed if Medicare's reasonable cost reimbursement principles were applicable to M+COs;
- \$120,888 of unsupported costs. We were unable to determine the reasonableness of these costs due to the lack of documentation.

The effect of including these administrative costs in the Plan's ACR proposal was to increase the amounts needed for administration, thus reducing any potential "excess" from the Medicare payment amounts. In addition, this methodology impacts the amount available to Medicare beneficiaries for additional benefits or reduced premiums.

By reducing the administrative costs for the above findings (i.e., \$132,471 and \$120,888) the administrative per member per month costs reported in the CY 2000 ACR would decrease by \$2.24, or \$434,613 (based on the Plan's projected Medicare enrollment levels).

Presently, there are no laws or regulations governing the allowability of costs included in the ACR proposal submitted by M+COs, unlike other areas of the Medicare program. Thus, no recommendations are addressed to the Plan.

In response to our draft report, the Plan officials did not dispute the specific factual findings contained in the report. They stated that the report did not make any recommendations and that the general cost guidelines pertinent to the Medicare fee-for-service program are not applicable to the Medicare+Choice program.

Page 3 - Neil Donovan

While this review examined only one plan, we believe that the results of this Plan, and others previously issued, highlight a significant problem - administrative costs deemed unallowable under Medicare's reasonable cost principles are being paid with Medicare funds. It appears that this problem may be systemic and that it extends beyond the nine plans previously reviewed. We are continuing our reviews at other MCOs. The results of these reviews will be shared with HCFA in the coming months so that appropriate legislative changes can be considered. We invite HCFA's comments on our review as it proceeds.

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-10-00-00013 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 PROPOSAL FOR A  
NORTHWEST MEDICARE+CHOICE  
ORGANIZATION FOR CONTRACT  
YEAR 2000**



**MAY 2000  
A-10-00-00013**

**Memorandum**

Date *MAY 11 2001*  
*Thomas D. Roslewicz*  
From Thomas D. Roslewicz  
Deputy Inspector General  
for Audit Services  
Subject

To Review of the Administrative Cost Component of the Adjusted Community Rate Proposal for a Northwest Medicare+Choice Organization for Contract Year 2000 (A-10-00-00013)

Neil Donovan  
Director, Audit Liaison Staff  
Health Care Financing Administration

This final report presents the results of our review of the administrative cost component of the adjusted community rate (ACR) proposal submitted to the Health Care Financing Administration (HCFA) by a Northwest Medicare+Choice organization (the Plan) for contract year (CY) 2000. We suggest that you distribute this report with HCFA components involved in the Medicare managed care organization operations, particularly the Center for Health Plans and Policy. This review is part of a nationwide review of administrative costs included in the ACR proposals that was requested by HCFA.

**EXECUTIVE SUMMARY****OBJECTIVE**

The objective of our review 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 principle of paying only reasonable costs.

**BACKGROUND**

The Medicare ACR process is designed for Medicare+Choice organizations (M+CO) to present to HCFA their estimates of the funds needed to cover the costs of providing the Medicare package of covered services to enrolled Medicare beneficiaries. An M+CO estimate includes medical and administrative costs for the upcoming year and must be supported by its operating experiences related to utilization and expenses. Beginning in CY 2000, M+COs were required to use their actual Medicare costs (base year) in developing their ACRs. For CY 2000, the base year was 1998.

## **SUMMARY OF FINDINGS AND CONCLUSION**

The Plan's CY 2000 ACR proposal contained 1998 base year costs of \$5.2 million of Medicare administrative costs. Based on our review of \$2.7 million of these costs, we found:

- \$132,471 of entertainment, travel, charitable contribution, and other costs that would not have been allowed if Medicare's reasonable cost reimbursement principles were applicable to M+COs;
- \$120,888 of unsupported costs. We were unable to determine the reasonableness of these costs due to the lack of documentation.

The effect of including these administrative costs in the Plan's ACR proposal was to increase the amounts needed for administration, thus reducing any potential "excess" from the Medicare payment amounts. In addition, this methodology impacts the amount available to Medicare beneficiaries for additional benefits or reduced premiums.

By reducing the administrative costs for the above findings (i.e., \$132,471 and \$120,888) the administrative per member per month (PMPM) costs reported in the CY 2000 ACR would decrease by \$2.24, or \$434,613 (based on the Plan's projected Medicare enrollment levels).

Presently, there are no laws or regulations governing the allowability of costs included in the ACR proposal submitted by M+COs, unlike other areas of the Medicare program. Thus, no recommendations are addressed to the Plan. Instead, based on the results of our nationwide review, we will be making recommendations to HCFA concerning the ACR process.

In response to our draft report, the Plan officials did not dispute the specific factual findings contained in the report. They stated that the report did not make any recommendations and that the general cost guidelines pertinent to the Medicare fee-for-service program are not applicable to the Medicare+Choice (M+C) program. We have summarized the Plan's comments and the Office of Audit Services response to those comments in the FINDINGS AND CONCLUSION section of the report. The complete text of the comments is included as the APPENDIX to this report.

## **INTRODUCTION**

### **BACKGROUND**

#### **Medicare Overview**

Under Title XVIII of the Social Security Act, the Medicare program provides health insurance to 39 million Americans age 65 and over, those who have permanent kidney failure, and certain people with disabilities. Within the Department of Health and Human Services, the Medicare program is administered by HCFA.

Medicare includes two related health insurance programs, hospital insurance, or Part A, and supplementary medical insurance, or Part B. Part A includes inpatient hospital, skilled nursing, rehabilitation, home health, and hospice services. Part B includes physician and outpatient hospital services and durable medical equipment.

The Balanced Budget Act of 1997 (P.L. 105-33) established Part C of the Medicare program, M+C. Starting in November 1999, the M+C program began offering Medicare beneficiaries a variety of health delivery models, including M+COs such as health maintenance organizations (HMO), preferred provider organizations, and provider sponsored organizations.

#### **Adjusted Community Rate Proposal**

The M+COs are required by section 1854 of the Social Security Act to compute an ACR proposal and submit it to HCFA prior to the beginning of the M+CO's contract period. The ACR proposal is prepared by an M+CO to justify its pricing structure for a benefit package offered to beneficiaries. The ACR proposal itemizes the costs for the benefit package provided by the M+CO, including administrative costs. The ACR requirement is designed to ensure that Medicare beneficiaries are not overcharged for the benefit package being offered.

The HCFA introduced revised instructions for completing the ACR in February 1998. One ACR proposal must be submitted for each health plan the organization intends to market. The ACR incorporates the revenue requirements of all its plans. The HCFA believes that the revised ACR will more accurately reflect the actual costs in pricing a benefit package. The CY 2000 ACRs were based on 1998 actual costs for both non-Medicare and Medicare enrollees.

### **SCOPE**

Our review was performed in accordance with generally accepted government auditing standards. Field work was performed at the offices of the Plan. The objective of our review

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 principle of paying only reasonable costs. We reviewed only those internal controls considered necessary to achieve our objective.

To accomplish our objective, we:

- reviewed applicable laws and regulations;
- discussed with Plan officials the ACR proposal process and how the administrative costs were derived and allocated to various lines of business;
- judgmentally selected and examined Medicare administrative costs; and
- analyzed the methodology that the Plan used to allocate administrative costs to Medicare in selected cost centers.

The administrative costs selected for review were generally from the following accounts in the Plan's general ledger: entertainment, meals, transportation, lodging, promotions, donations, advertising, outside printing, postage, legal services, and other professional services.

The Plan allocated \$5.9 million of Medicare administrative costs to the plans it operated under its M+C line of business in CY 1998. Only \$5.2 million of Medicare administrative costs were included in the Plan's ACR proposals because one of its M+C plans was discontinued. We reviewed cost items from the general ledger totaling \$2.7 million. Because the transactions tested were judgmentally selected, our results cannot be considered representative of the universe of all transactions and cannot be projected to the total administrative costs submitted by the Plan.

## **FINDINGS AND CONCLUSION**

### **FINDINGS**

We found that the administrative cost component of the CY 2000 ACR proposal included \$132,471 of costs that would not be considered reasonable, necessary, and allocable if Medicare's general principle of paying only reasonable costs were applied to the ACR process. We also identified \$120,888 of costs that were not adequately supported.

**Costs Not Considered Allowable**

The Plan included administrative costs in its ACR proposal such as entertainment, travel, charitable contributions, and other costs that would not be considered reasonable, necessary, and allocable if Medicare’s general principle of paying only reasonable costs were applied to M+COs. Of the \$2.7 million in transactions tested, we found administrative costs totaling \$132,471 that would not be allowed when compared to the Medicare program’s general principle of paying only reasonable costs. The following table details these costs allocated to the Medicare line of business.

DESCRIPTION	TOTAL
<b>ENTERTAINMENT:</b>	
Gifts	\$ 10,643
Social Activities	\$ 2,500
Catering	\$ 4,612
Staff Meals	\$ 28,508
Other (alcoholic beverages, transportation, parties, etc.)	\$ 18,664
CHARITABLE CONTRIBUTIONS	\$ 18,830
ACCOUNTING ERRORS	\$ 12,390
UNALLOCABLE COSTS	\$ 34,863
TRAVEL IN EXCESS OF ALLOWABLE PER DIEM	\$ 1,461
<b>TOTAL QUESTIONABLE COSTS</b>	<b>\$ 132,471</b>

Because the plan carries other Federal contracts, many of the entertainment costs that we have separated into subcategories of entertainment were already in accounts defined by the Plan as unallowable costs for the purposes of Federal contracts; e.g., the Federal Employees Health Benefits Program. These costs were included in the administrative costs of the ACR proposal because there were no Federal requirements for excluding them.

**Unsupported Costs**

The Plan was unable to provide supporting documentation for \$120,888 of administrative costs examined. While the costs may be reasonable, necessary, and allocable using the Medicare program’s principles of paying only reasonable costs, the Plan did not provide support to allow us to fully evaluate the costs. The unsupported administrative costs are included in the following table.

DESCRIPTION	TOTAL
CONSULTANT SERVICES	\$ 47,250
UNSUPPORTED TRAVEL COSTS	\$ 10,335
OTHER UNSUPPORTED COSTS	\$ 63,303
<b>TOTAL UNSUPPORTED COSTS</b>	<b>\$ 120,888</b>

Unsupported consultant services costs consisted of payments for which Plan officials could not provide the necessary statement of work and work product. Unsupported travel costs included charges for mileage reimbursement with insufficient or no documentation. Other unsupported costs included transactions with missing invoices, incomplete support, or questionable allocation methods.

### **Impact on the ACR Proposal**

Our review of the CY 2000 ACR proposal submission showed that \$253,359 in base year costs would not be considered reasonable, necessary, and allocable if Medicare's general principle of paying only reasonable costs were applied to the ACR process. We calculated that these adjustments would have reduced the administrative costs reported in the CY 2000 ACR by \$2.24 PMPM, or \$434,613.

Administrative costs for the ACR proposal 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. The relative cost ratio is applied to estimated non-Medicare administrative costs included in the initial rate for the year being reported upon to arrive at the Medicare administrative costs. By reducing the base year administrative costs by \$253,359 the relative cost ratios were changed. By multiplying these adjusted relative cost ratios by the initial rate, we determined that the administrative costs in the CY 2000 ACR proposal would have been reduced by \$2.24 PMPM, or \$434,613.

The effect of including these administrative costs in the Plan's ACR proposal was to increase the amounts needed for administration, thus reducing any potential "excess" from the Medicare payment amounts. In addition, this methodology impacts the amounts available to Medicare beneficiaries for additional benefits or reduced premiums.

### **CONCLUSION**

We recognize that presently there is no statutory or regulatory authority governing allowability of costs in the ACR process, unlike other areas of the Medicare program.

However, we question whether many of the administrative costs allocated to the Plan's Medicare line of business in FY 1998 should be included in future ACR proposals, should the Plan choose to submit any. For example, regulations covering HMOs that contract with HCFA on a cost reimbursement basis provide specific parameters delineating allowable administrative costs for enrollment and marketing. These same guidelines, however, are not used in administering the M+C contracts. Thus, no recommendations were addressed to the Plan. Instead, we are sharing the results of this review with HCFA so that appropriate legislative changes can be considered.

## **AUDITEE COMMENTS**

In response to our draft report, the Plan officials did not dispute the specific factual findings contained in the report. They stated that the report did not make any recommendations and that the general cost guidelines pertinent to the Medicare fee-for-service program are not applicable to the M+C program.

The Plan officials further stated that they had used the ACR proposal structure and formulas and followed the rules for computing the administrative costs specified by HCFA. They also stated that many of the administrative costs considered "questionable" reflect sales and retention activities geared for the M+C population that do not apply to the Medicare fee-for-service program currently administered by HCFA. And finally, the officials stated that the application of reimbursement principles to a community-rated HMO program, where the MCO bears the insurance risk, is not appropriate for many reasons already discussed by other MCOs in responses to other OIG reports relating to the nationwide review.

## **OIG RESPONSE**

Notwithstanding the lack of specific regulations regarding the admissibility of administrative costs for M+C contracts, we believe that certain administrative costs are not appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs. Therefore, those costs that would not be allowable under other areas of the Medicare program should also be eliminated from future ACR calculations.

## **APPENDIX**

**RESPONSE TO OFFICE OF INSPECTOR GENERAL DRAFT REPORT**

**"Review of the Administrative Cost Component of the Adjusted Community Rate Proposal for a Northwest Risk-Based Managed Care Organization for Contract Year 2000."**

We do not dispute the specific factual findings contained in the report primarily because: 1) the OIG audit report did not make any recommendations with respect to the health plan; and, 2) the general cost guidelines pertinent to the Medicare fee-for-service program are not applicable to the Medicare+Choice program. In addition, we have the following comments related to the overall scope of the OIG's nationwide review:

- We used the ACRP structure and formulas as specified by HCFA.
- We followed the HCFA rules for computing the administrative costs.
- Many of the administrative costs considered "questionable" reflect sales and retention activities geared for the Medicare+Choice population that do not apply to the Medicare fee-for-service program as currently administered by HCFA.
- The application of Medicare fee-for-service administrative cost reimbursement principles to a community rated HMO program where the Managed Care Organization (MCO) bears the insurance risk is not appropriate for many reasons. Rather than repeat all the reasons here, we refer the OIG, HCFA and other policy makers to the responses of other MCOs to this nationwide review.