

**Memorandum**

JUN 12 2001

Date

From

Thomas D. Roslewicz
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 New York Medicare+Choice Organization (A-02-00-01034)

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 New York Medicare+Choice Organization."

We suggest that you share this report with Health Care Financing Administration (HCFA) components involved in the Medicare managed care organization operations, particularly the Center for Health Plans and Policy. This audit was conducted as part of a nationwide review of the administrative costs included in the Contract Year (CY) 2000 adjusted community rate (ACR) proposals submitted to HCFA. The objectives of this review were to examine the administrative cost component of the ACR proposals submitted to HCFA by a New York Medicare+Choice organization (M+CO) and to assess whether the costs were appropriate when compared to the Medicare program's general reasonable cost principles.

The Office of Inspector General (OIG) in January 2000 reported that \$66.3 million of the administrative costs included in the ACR proposals submitted by nine managed care organizations (MCO) would have been unallowable had the MCOs been required to follow Medicare's general reasonable cost principles.¹ That report recommended that HCFA pursue legislation which would require MCOs to follow Medicare's general reasonable cost principles with respect to their administrative costs. Although HCFA did not concur with this recommendation, they noted that the recently revised ACR methodology should give HCFA a better means of identifying reasonable administrative costs and modifying the MCOs' proposed costs as necessary.

Based on the results of the nine audits, HCFA requested that OIG examine M+COs to determine if M+COs were including such costs in computing their ACR proposals under

¹ "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)

the revised format. In addition, the HCFA Administrator expressed concerns about “. . .reporting inappropriate administrative costs. . . .” in ACR proposals in a notice issued to all M+COs on April 24, 2000. This review was conducted in response to HCFA’s concerns about “inappropriate” costs and their request for additional audits of administrative costs incurred by M+COs.

Unlike other entities in the Medicare program, an M+CO is not presently subject to statutes or regulations which would limit its administrative costs. For example, the ACR proposal guidelines do not include cost principles that limit Medicare administrative costs to reasonable, necessary, and/or allocable costs. Since HCFA does not specify which administrative costs may be included in an ACR proposal, our review was based on the guidelines HCFA applies to cost-based managed care organizations and to other Medicare contractors (e.g., contractors and providers in the fee-for-service program). These same guidelines, however, are not currently used in administering the M+CO contracts.

The review identified \$96,994 (Medicare share) of administrative costs that would not be appropriate if the Medicare program’s general reasonable cost principles were applied to M+COs. These costs included: (1) entertainment, meals, and employee morale expenses; (2) charitable contributions and sponsorships; (3) lobbying costs; (4) unsupported costs; (5) marketing and enrollment expenses; and (6) other costs.

The effect of excluding these costs from the M+CO’s ACR proposal would be to decrease the CY 2000 administrative costs by \$0.51 per member per month (PMPM). Applying this reduction in PMPM costs to the M+COs’ ACR proposals, we estimated a total reduction of \$238,154 in administrative costs that could have been made available to Medicare beneficiaries for reduced copayments or additional benefits.

In response to our draft report, the M+CO did not dispute the specific factual findings contained in the report.

If you have any questions, please contact George M. Reeb, Assistant Inspector General for Health Care Financing Audits, at (410) 786-7104.

Please refer to Common Identification Number A-02-00-01034 in all correspondence relating to this report.

Attachment

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF THE ADMINISTRATIVE
COST COMPONENT OF THE ADJUSTED
COMMUNITY RATE PROPOSAL FOR A
NEW YORK MEDICARE+CHOICE
ORGANIZATION**



**JUNE 2001
A-02-00-01034**

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Subject

To

Review of the Administrative Cost Component of the Adjusted Community Rate Proposal
for a New York Medicare+Choice Organization (A-02-00-01034)

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 Proposal for a New York Medicare+Choice Organization."

This audit was conducted as part of a nationwide review of the administrative costs included in the Contract Year (CY) 2000 adjusted community rate (ACR) proposals submitted to the Health Care Financing Administration (HCFA). The objectives of this review were to examine the administrative cost component of the ACR proposals submitted to HCFA by a New York Medicare+Choice organization (M+CO) and to assess whether the costs were appropriate when compared to the Medicare program's general reasonable cost principles.

Through the ACR process, an M+CO presents HCFA with an estimate of the funds needed to cover the benefit and administrative costs associated with providing services to its Medicare members. The CY 2000 ACR proposal is based on historical (1998) cost data allocated among three components: direct medical care, administration, and additional revenues (e.g., profit, loss, or amounts set aside for risk reserves). All cost and revenue data in the ACR proposal is presented on a per member per month (PMPM) basis. Any excess of projected CY 2000 HCFA funds over the cost of providing Medicare-covered services may be used to determine the extent of additional benefits offered, the premiums charged to Medicare beneficiaries, or the M+CO's contributions to a benefit stabilization fund.

Unlike other entities in the Medicare program, an M+CO is not presently subject to statutes or regulations which would limit its administrative costs. For example, the ACR proposal guidelines do not include cost principles that limit Medicare administrative costs to reasonable, necessary, and/or allocable costs. Since HCFA does not specify which administrative costs may be included in an ACR proposal, our review was based on the guidelines HCFA applies to cost-based managed care organizations and to other Medicare contractors (e.g., contractors and providers in the fee-for-service program). These same guidelines, however, are not currently used in administering the M+CO contracts.

The review identified \$96,994 (Medicare share) of administrative costs that would not be appropriate if the Medicare program's general reasonable cost principles were applied to M+COs. These costs included: (1) entertainment, meals, and employee morale expenses; (2) charitable contributions and sponsorships; (3) lobbying costs; (4) unsupported costs; (5) marketing and enrollment expenses; and (6) other costs.

The effect of excluding these costs from the M+CO's ACR proposal would be to decrease the CY 2000 administrative costs by \$0.51 PMPM. Applying this reduction in PMPM costs to the M+CO's ACR proposals, we estimated a total reduction of \$238,154 in administrative costs that could have been made available to Medicare beneficiaries for reduced copayments or additional benefits.

Since the New York M+CO was not prohibited from including any of the costs discussed above in its ACR proposal, we are not providing any recommendations in this report. However, we believe that the use of Medicare trust funds in paying monthly M+CO capitation payments should not exceed amounts that would be allowed using existing regulations which apply prudent and cost-conscious management concepts in other areas of the Medicare program.

INTRODUCTION

BACKGROUND

The Balanced Budget Act of 1997 (BBA) established the M+CO program with the primary goal of providing a wider range of health plan choices to Medicare beneficiaries. The managed care options available to beneficiaries under the program include coordinated care plans, such as health maintenance organizations, medical savings account plans, and private fee-for-service plans. The BBA also modified the payment methodology under the Medicare+Choice program in order to correct excess payments, reduce geographic variations in payment, and align M+CO payments to reflect beneficiaries' health status. Under the program, an M+CO receives a predetermined capitation payment for each of its Medicare members each month. In exchange for the capitation payments, an M+CO is required to provide all Medicare-covered services to its members.

Section 1854 of the Social Security Act requires every M+CO to submit an ACR proposal to HCFA each year. Through the ACR process, an M+CO presents HCFA with an estimate of the funds needed to cover the benefit and administrative costs associated with providing services to its Medicare members. Any excess of HCFA funds over the cost of providing Medicare-covered services may be used to determine the extent of additional benefits offered, the premiums charged to Medicare beneficiaries or the M+CO's contributions to a benefit stabilization fund.

The HCFA's revised instructions for the preparation of CY 2000 ACR proposals require M+COs to report the actual Medicare costs they incurred in 1998. In its ACR proposal, an M+CO must also calculate the average premium that it would charge its general non-Medicare population for the benefits covered under its Medicare plan. The premium income presented on the ACR proposal is allocated among three components: direct medical care, administration, and additional revenues (e.g., profit, loss, or amounts set aside for risk reserves). All cost and revenue data in the ACR proposal is presented on a PMPM basis.

The historical (1998) cost data in the ACR proposal is especially important due to changes brought about by the BBA. For example, under the BBA, the projected Medicare administrative costs for CY 2000 are determined by a ratio which compares actual administrative costs incurred for Medicare beneficiaries in 1998 to actual administrative costs incurred for non-Medicare members in the same year.

The ACR proposal guidelines do not, however, include cost principles that limit Medicare administrative costs to reasonable, necessary, and allocable costs. The Office of Inspector General (OIG) in January 2000 reported that \$66.3 million of the administrative costs included in the ACR proposals submitted by nine managed care organizations (MCO) would have been unallowable had the MCOs been required to follow Medicare's general reasonable cost principles.¹ That report recommended that HCFA pursue legislation which would require MCOs to follow Medicare's general reasonable cost principles with respect to their administrative costs. Although HCFA did not concur with this recommendation, they noted that the recently revised ACR methodology should give HCFA a better means of identifying reasonable administrative costs and modifying the MCOs' proposed costs as necessary.

Based on the results of the nine audits, HCFA requested that OIG examine M+COs to determine if M+COs were continuing to include such costs in computing their ACR proposals under its revised format. In addition, the HCFA Administrator expressed concerns about “. . .reporting inappropriate administrative costs. . .” in ACR proposals in a notice issued to all M+COs on April 24, 2000. This review was conducted in response to HCFA's concerns about “inappropriate” costs and their request for additional audits of administrative costs incurred by M+COs.

¹ “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)

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of this review were to examine the administrative cost component of the CY 2000 ACR proposals submitted by a New York M+CO and to assess whether the costs were appropriate when compared to the Medicare program's general reasonable cost principles.

To accomplish these objectives, we:

- < reviewed applicable laws and regulations;
- < held discussions with the M+CO officials about their ACR process and how administrative costs on the 2000 ACR proposal were derived; and
- < selected and reviewed specific categories of administrative costs from the M+CO's 1998 (base year) general ledger.

From total 1998 (base year) administrative costs of \$17,641,179, we judgmentally selected 4,008 administrative cost items (invoices and journal entries) totaling \$5,842,652 for review. Since HCFA guidelines do not specify which administrative costs may be included in an ACR proposal, we reviewed each of these items using the guidelines HCFA applies to cost-based managed care organizations and to other Medicare contractors (e.g., contractors and providers in the fee-for-service program).²

The audit was performed in accordance with generally accepted government auditing standards. The objectives of this financial related audit did not require an understanding or an assessment of the internal control structure of the New York M+CO. It is also noted that since the sample items were not randomly selected, our findings cannot be projected to the universe of administrative costs included in the ACR proposal. Field work was performed at the M+CO's offices in New York from June through December 2000.

²The Federal Acquisition Regulations (FAR) are the primary regulations for use by all Federal Executive agencies in their acquisition of supplies and services with appropriated funds. Part 31 of the FAR contains cost principles and procedures for (a) the pricing of contracts, subcontracts, and modifications to these whenever cost analysis is performed and (b) the determination, negotiation, or allowance of costs when required by a contract clause

FINDINGS AND RECOMMENDATIONS

Of the \$5,842,652 in administrative costs selected for review, \$96,994 (Medicare share) would not be appropriate when compared to the Medicare program’s general reasonable cost principles. Under the reasonable cost principles which HCFA applies to cost-based managed care organizations and to other Medicare contractors and providers in the fee-for-service program, the following administrative costs included in the New York M+CO’s ACR proposal would not be allowable:

Expense Category	Amount
Entertainment, Meals, and Employee Morale	\$32,371
Charitable Contributions and Sponsorships	19,765
Lobbying Costs	19,249
Unsupported Costs	9,666
Marketing and Enrollment Costs	7,997
Other Costs	7,946
	\$96,994

- C **Entertainment/Meals/Employee Morale** (\$32,371). These costs included season tickets for professional sporting events and for a suite at a sports arena; the cost of a Golf Classic hospitality package; entertainment and other expenses for a “Walk Down Memory Lane” event; a band for performance at a senior center; costs for off-site sales meetings; and employee meal and water expenses.
- C **Charitable Contributions/Sponsorships** (\$19,765). This amount included costs for contributions to charitable and other organizations for dinners, dances, award celebrations, golf tournaments, and other sporting events sponsored by those organizations.
- C **Lobbying Costs** (\$19,249). These costs included the lobbying portion of dues to professional organizations as well as payments to consultants hired to represent management’s interests with respect to governmental entities.
- C **Unsupported Costs** (\$9,666). This amount represented items which were either unsupported or for which the support available was insufficient to determine whether the costs should have been allocated to the M+CO.

- C **Marketing/Enrollment Costs** (\$7,997). These costs included payment of a Medicare member's personal dues for the American Association of Retired Persons as well as promotional activities such as bus trips for seniors to casinos in Atlantic City and in Connecticut.
- C **Other Costs** (\$7,946). These items include duplicated payments for travel costs; insurance premiums for officers of the M+CO that would not be allowable under the Medicare program's reasonable cost principles; the cost of legal advertisements about rate hearings for the M+CO's commercial lines of business; and amounts incurred for lottery tickets and alcoholic beverages.

The effect of excluding these costs from the M+CO's ACR proposal would be to decrease the CY 2000 administrative costs by \$0.51 PMPM. Applying this reduction in PMPM costs to the M+CO's ACR proposals, we estimated a total reduction of \$238,154 in administrative costs that could have been made available to Medicare beneficiaries for reduced copayments or additional benefits.

In conclusion, our review showed that certain costs included in the administrative cost component of the New York M+CO's ACR proposals were inconsistent with the Medicare program's general reasonable cost principles. While we recognize that an M+CO is not presently subject to statutes or regulations which would limit its administrative costs, we question the equity of including costs in the ACR process that are unallowable in other areas of the Medicare program.

RECOMMENDATIONS

Since the New York M+CO is not prohibited from including any of the costs discussed above in its ACR proposal, we are not addressing any recommendations to the M+CO in this report. As previously noted, this audit is part of a nationwide review of the ACR process and similar audits are being performed at several other M+COs.

Although we are not addressing any recommendations to the New York M+CO, we believe that the use of Medicare trust funds in paying monthly M+CO capitation payments should not exceed amounts that would be allowed using existing regulations which apply prudent and cost-conscious management concepts in other areas of the Medicare program. Notwithstanding the lack of specific guidelines for M+CO contracts, we believe that those costs that would not be allowable to other Medicare contractors and providers should be eliminated from the Medicare ACR proposal calculations. Therefore, the results of these reviews are being shared with HCFA so that appropriate legislative action can be considered.

The New York MCO's Comments

The New York M+CO stated that although some of the costs identified in this report would not conform to HCFA's general reasonable cost principles, M+COs are not presently subject

to these principles. The New York M+CO also stated that application of the reasonable cost guidelines to an M+CO could both distort the operating results for this line of business and also result in the need for other lines of business to subsidize the Medicare program. The full text of the M+CO's response is attached as an Appendix to this report.

OIG Response

It is important to reiterate that the objective of the audit was limited to an assessment of the administrative cost component of the ACR proposal and the nature of the administrative costs charged to the Medicare program. We also note that some of the costs identified in the report were directly and exclusively charged to the Medicare line of business while others were allocated among several lines of business, including Medicare. With respect to the M+CO's concerns that other lines of business might have to subsidize some of the costs, we believe that if HCFA were to establish guidelines on the administrative cost component of the ACR proposal, the M+CO would have the opportunity to carefully consider the propriety of the costs before they are incurred and could avoid charging these costs to other lines of business.

OIG Note: All Information identifying the name and address of the New York M+CO was deleted from the M+CO's response ,

APPENDIX

March 27, 2001

Timothy J. Horgan
Regional Inspector General for Audit Services
Office of Inspector General
Department of Health and Human Services
Jacob K. Javits Federal Building
26 Federal Plaza
New York, New York 10278

Re: Common Identification Number: A-02-00-01034

Dear Mr. Horgan:

Thank you for the opportunity to review and comment on the issues raised in your draft report on the administrative costs in our 2000 Adjusted Community Rate Proposal ("ACRP"). As noted in the draft audit report, as a risk-based MCO, our ACRP is not subject to the guidelines that HCFA applies to cost based MCOs and other Medicare contractors (e.g. fee-for-service). However, we agree that if those guidelines did apply, certain expenses included in the ACRP would not conform. As such and as you found, our reported administrative expense was in line with the HCFA guidelines that do govern the ACRP.

In assessing our participation in the Medicare+Choice Program, the company looks at all costs associated with administering the program. Excluding any of these reasonable and necessary costs would distort an objective assessment of the Program's operating results. Specifically, the cost based guidelines cannot and do not reflect activities and expenses that are reasonable and necessary to operate as a viable risk bearing entity. If such costs were precluded due to the application of the cost based guidelines, it would mean using our other lines of business to subsidize the Medicare+Choice Program.

The company is committed to following all HCFA guidelines pertaining to the ACRP for as long as it participates in the program. We appreciate your efforts and hope that you found our staff to be cooperative and informative. Please feel free to call us if you have any questions or would like to discuss anything further.