APR 10 2008

TO: Kerry Weems
Acting Administrator
Centers for Medicare & Medicaid Services

FROM: Daniel R. Levinson
Inspector General

SUBJECT: Review of Quality Improvement Organization in Maryland (A-03-06-01650)

Attached is an advance copy of our final report on our review of the Quality Improvement Organization (QIO) in Maryland. In each State, the Centers for Medicare & Medicaid Services (CMS) contracts with QIOs, which were established to promote the effective, efficient, and economical delivery of Medicare health care services and the quality of those services. The Senate Finance Committee requested that the Office of Inspector General (OIG) assess the fiscal integrity of the QIOs with respect to six specific subject areas. This report is one of a series of nine audits of QIOs, which responded to that request. In Maryland, the Delmarva Foundation for Medical Care (DFMC) was the QIO for the period November 1, 2002, through October 31, 2005. For this 3-year period, known as the seventh scope of work (SOW), DFMC received $22.8 million in Federal reimbursement for the QIO contract. We will issue this report to DFMC within 5 business days.

Our objective was to review the six fiscal integrity areas requested by the Senate Finance Committee. Specifically, the costs we reviewed related to board member and executive staff compensation; board member and executive staff travel; costs relating to legal fees, including administrative charges; equipment and administrative charges; business relationships and conflicts of interests; and contract modifications.

We found that DFMC incurred approximately $1.6 million of costs that were improperly classified as indirect costs. These costs were direct costs totaling $89,026 for recruiting that should have been charged to the QIO contract and rents and other costs totaling $1,548,509 attributable to specific contracts with State governments that should not have been included in the indirect costs. Because indirect costs are used to calculate the indirect cost rates, inflating these costs may have resulted in inflated indirect costs charged to this SOW.

We recommend that DFMC work with CMS to resolve the status of the $1,637,535 in questioned indirect costs as part of the final settlement of the SOW.

In its comments on our draft report, the QIO took exception to our recommendation and offered five specific areas of disagreement with our representation of its accounting practices. However, the QIO stated that it changed its accounting practices as of July 1, 2007.

After reviewing the QIO's comments, we disagree with its interpretation of the criteria and continue to support our findings. We have modified our report by clarifying our data analysis. We also limited the recommendation to the QIO contract and recommended that DFMC resolve the questioned costs with CMS. The Appendix presents the QIO's comments in their entirety, except for a 2-page attachment related to Defense Contract Audit Agency correspondence concerning fiscal year 2003 indirect cost rates, which the QIO considers proprietary information.

If you have any questions or comments about this report, please do not hesitate to call me, or your staff may contact George M. Reeb, Assistant Inspector General for the Centers for Medicare & Medicaid Services Audits, at (410) 786-7104 or through e-mail at George.Reeb@oig.hhs.gov or Stephen Virbitsky, Regional Inspector General for Audit Services, Region III, at (215) 861-4470 or through e-mail at Stephen.Virbitsky@oig.hhs.gov. Please refer to report number A-03-06-001650 in all correspondence.

Attachment

DEPARTMENT OF HEALTH & HUMAN SERVICES

OFFICE OF INSPECTOR GENERAL

Office of Audit Services – Region III
Public Ledger Building, Room 316
150 South Independence Mall West
Philadelphia, PA 19106-3499

APR 14 2008

Report Number: A-03-06-001650

Christian E. Jensen, M.D., M.P.H.
President and Chief Executive Officer
Delmarva Foundation
9240 Centreville Road
Easton, Maryland 21601

Dear Dr. Jensen:

Enclosed is the U.S. Department of Health and Human Services (HHS), Office of Inspector General (OIG) final report entitled "Review of Quality Improvement Organization in Maryland." We will forward a copy of this report to the HHS action official noted on the following page for review and any action deemed necessary.

The HHS action official will make final determination as to actions taken on all matters reported. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

Pursuant to the principles of the Freedom of Information Act (5 U.S.C. § 552, as amended by Public Law 104-231), OIG reports generally are made available to the public to the extent the information is not subject to exemptions in the Act (45 CFR part 5). Accordingly, within 10 business days after the final report is issued, it will be posted on the Internet at http://oig.hhs.gov.

If you have any questions or comments about this report, please do not hesitate to call me, or contact Robert Baiocco, Audit Manager, at (215) 861-4486 or through e-mail at Robert.Baiocco@oig.hhs.gov. Please refer to report number A-03-06-01650 in all correspondence.

Sincerely,

Stephen Virbitsky
Regional Inspector General
for Audit Services

Enclosures

Direct Reply to HHS Action Official:

James Randolph Farris, M.D., Consortium Administrator
Consortium for Quality Improvement and
Survey & Certification Operations
Centers for Medicare & Medicaid Services
1301 Young Street, Suite 714
Dallas, Texas 75202

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF QUALITY IMPROVEMENT ORGANIZATION IN MARYLAND

Daniel R. Levinson
Inspector General

April 2008
A-03-06-01650

Office of Inspector General

http://oig.hhs.gov

The mission of the Office of Inspector General (OIG), as mandated by Public Law 95-452, as amended, is to protect the integrity of the Department of Health and Human Services (HHS) programs, as well as the health and welfare of beneficiaries served by those programs. This statutory mission is carried out through a nationwide network of audits, investigations, and inspections conducted by the following operating components:

Office of Audit Services

The Office of Audit Services (OAS) provides auditing services for HHS, either by conducting audits with its own audit resources or by overseeing audit work done by others. Audits examine the performance of HHS programs and/or its grantees and contractors in carrying out their respective responsibilities and are intended to provide independent assessments of HHS programs and operations. These assessments help reduce waste, abuse, and mismanagement and promote economy and efficiency throughout HHS.

Office of Evaluation and Inspections

The Office of Evaluation and Inspections (OEI) conducts national evaluations to provide HHS, Congress, and the public with timely, useful, and reliable information on significant issues. These evaluations focus on preventing fraud, waste, or abuse and promoting economy, efficiency, and effectiveness of departmental programs. To promote impact, OEI reports also present practical recommendations for improving program operations.

Office of Investigations

The Office of Investigations (OI) conducts criminal, civil, and administrative investigations of fraud and misconduct related to HHS programs, operations, and beneficiaries. With investigators working in all 50 States and the District of Columbia, OI utilizes its resources by actively coordinating with the Department of Justice and other Federal, State, and local law enforcement authorities. The investigative efforts of OI often lead to criminal convictions, administrative sanctions, and/or civil monetary penalties.

Office of Counsel to the Inspector General

The Office of Counsel to the Inspector General (OCIG) provides general legal services to OIG, rendering advice and opinions on HHS programs and operations and providing all legal support for OIG's internal operations. OCIG represents OIG in all civil and administrative fraud and abuse cases involving HHS programs, including False Claims Act, program exclusion, and civil monetary penalty cases. In connection with these cases, OCIG also negotiates and monitors corporate integrity agreements. OCIG renders advisory opinions, issues compliance program guidance, publishes fraud alerts, and provides other guidance to the health care industry concerning the anti-kickback statute and other OIG enforcement authorities.

Notices

THIS REPORT IS AVAILABLE TO THE PUBLIC
at http://oig.hhs.gov

Pursuant to the principles of the Freedom of Information Act, 5 U.S.C. § 552, as amended by Public Law 104-231, Office of Inspector General reports generally are made available to the public to the extent the information is not subject to exemptions in the Act (45 CFR part 5).

OFFICE OF AUDIT SERVICES FINDINGS AND OPINIONS

The designation of financial or management practices as questionable, a recommendation for the disallowance of costs incurred or claimed, and any other conclusions and recommendations in this report represent the findings and opinions of OAS. Authorized officials of the HHS operating divisions will make final determination on these matters.

EXECUTIVE SUMMARY

BACKGROUND

In the Medicare program, the Centers for Medicare & Medicaid Services (CMS) contracts with Quality Improvement Organizations (QIO) in each State. Pursuant to section 1862(g) of the Social Security Act, QIOs were established for "the purposes of promoting the effective, efficient, and economical delivery of health care services, and of promoting the quality of services . . . ."

QIOs submit vouchers for Federal reimbursement to CMS monthly. The vouchers and reimbursements include amounts for both direct and indirect costs. The QIOs determine the amount of indirect costs to claim by multiplying indirect cost rates against their direct costs. During the contract period, CMS usually is unable to calculate an indirect cost rate. Therefore, QIOs use provisional rates to determine indirect costs. After the close of each QIO's fiscal year (FY), the Defense Contract Audit Agency reviews the organization's actual direct and indirect costs. The CMS contracting officer considers the Defense Contract Audit Agency's recommendations in establishing the final rate and performing the final cost settlement.

The Delmarva Foundation for Medical Care (DFMC) was the Maryland QIO for the period November 1, 2002, through October 31, 2005. For this 3-year period, known as the seventh scope of work (SOW), DFMC received $22.8 million in Federal reimbursement to perform the core contract and 14 special studies. For its FYs ending June 30, 2003, through June 30, 2005, DFMC incurred total costs of approximately $81.3 million to support all lines of business, including the QIO contract. As of April 3, 2008, CMS had not performed the final cost settlement for the seventh SOW.

The Senate Finance Committee requested that the Office of Inspector General assess the fiscal integrity of the QIOs. The Senate Finance Committee requested that we review, at a minimum, the following areas:

1. board member and executive staff compensation;
2. board member and executive staff travel;
3. costs relating to legal fees, including administrative charges;
4. equipment and administrative charges;
5. business relationships and conflicts of interest; and
6. contract modifications.

OBJECTIVE

Our objective was to review the six fiscal integrity areas requested by the Senate Finance Committee.

SUMMARY OF FINDING

Of the $23.7 million of costs reviewed, $22.1 million appeared reasonable for Federal reimbursement. Of the remaining costs, DFMC incurred approximately $1.6 million of costs that were improperly classified as indirect costs. These costs were direct costs totaling $89,026 for recruiting that should have been charged to the QIO contract and rents and other costs totaling $1,548,509 attributable to specific contracts with State governments that should not have been included in the indirect costs. Because indirect costs are used to calculate the indirect cost rates, inflating these costs may have resulted in inflated indirect costs charged to this SOW.

RECOMMENDATION

We recommend that DFMC work with CMS to resolve the status of the $1,637,535 in questioned indirect costs as part of the final settlement of the SOW.

DELMARVA FOUNDATION FOR MEDICAL CARE'S COMMENTS

In its comments on our draft report, DFMC took exception to our recommendation and offered five specific areas of disagreement with our representation of its accounting practices. However, DFMC stated that it changed its accounting practices as of July 1, 2007.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

After reviewing DFMC's comments, we disagree with its interpretation of the criteria and continue to support our findings. We have modified our report by clarifying our data analysis. We also limited the recommendation to the QIO contract and recommended that DMFC resolve the questioned costs with CMS. The Appendix presents DFMC's comments in their entirety, except for a 2-page attachment related to Defense Contract Audit Agency correspondence concerning FY 2003 indirect cost rates, which DFMC considers proprietary information.

TABLE OF CONTENTS

Page

INTRODUCTION

BACKGROUND

Quality Improvement Organization Program

Part B of Title XI of the Social Security Act (the Act), as amended by the Peer Review Improvement Act of 1982, established the Utilization and Quality Control Peer Review Organization Program, now known as the Quality Improvement Organization (QIO) Program. Pursuant to section 1862(g) of the Act, QIOs were established to promote the effective, efficient, and economical delivery of Medicare health care services and the quality of those services.

Pursuant to 42 CFR § 475.101, "to be eligible for a QIO contract an organization must – (a) Be either a physician-sponsored organization . . . or a physician-access organization . . . and (b) Demonstrate its ability to perform review . . . ."

The Centers for Medicare & Medicaid Services (CMS) awards the contracts for 41 QIO organizations, which administer 53 QIO contracts (all 50 States plus the District of Columbia, Puerto Rico, and the U.S. Virgin Islands), every 3 years. Each contract requires a specific scope of work (SOW). Seven SOWs have been completed. The SOW for each contract may be modified to make adjustments to the contract tasks. Certain modifications, referred to as special studies, generally receive the majority of funding increases. Federal funding for QIOs was budgeted at approximately $1.3 billion for the seventh SOW.

The Office of Management and Budget (OMB) Circular A-122, "Cost Principles for Non-Profit Organizations," as revised June 1, 1998, establishes the principles for determining allowable costs with respect to contracts with nonprofit organizations.[1]

Claims for Federal Reimbursement

Pursuant to its contract with CMS, each QIO submits vouchers to CMS monthly. The vouchers include claims for both direct and indirect costs. Pursuant to OMB Circular A-122, Attachment A, direct costs are amounts "that can be identified specifically with a particular final cost objective" (section B.1), and indirect costs are amounts "that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective" (section C.1). An indirect cost rate is established for each contract and is generally calculated by dividing allowable indirect costs by all direct costs. QIOs determine the amount of indirect costs to claim by multiplying an indirect cost rate against direct costs incurred for the contract.[2]

---

[1]In this report, citations to OMB Circular A-122 are to the June 1, 1998, version. On May 10, 2004, OMB revised the circular, which generally became effective on the May 10, 2004, publication date, during the seventh SOW (70 Federal Register 51927 (Aug. 31, 2005)). However, the circular states that, for existing awards, the new principles may be applied if the organization and the cognizant Federal agency agree (section 9 of OMB Circular A-122, as revised May 10, 2004). The 2004 version does not apply to this QIO contract because the parties did not make such an agreement.

[2]Some of the direct costs, including passthrough costs, do not receive an allocation of indirect costs. Section G.3 of the QIO contract requires QIOs to exclude their passthrough costs in the calculation of indirect costs.

During the contract period, CMS usually is unable to calculate an exact cost rate. Therefore, QIOs use provisional rates to determine indirect costs. Pursuant to OMB Circular A-122, Attachment A, section E.1.e, a provisional rate is a temporary indirect cost rate "applicable to a specified period which is used for funding, interim reimbursement, and reporting indirect costs on awards pending the establishment of a final rate for the period." After the close of a QIO's fiscal year (FY), CMS contracts with the Defense Contract Audit Agency (DCAA) to review the indirect cost rate proposals, which contain the actual direct and indirect costs, and to make recommendations as to the final rates for the FY. The CMS contracting officer considers DCAA's recommendations in establishing the final rates for each QIO.

Maryland Quality Improvement Organization

The Delmarva Foundation for Medical Care (DFMC), headquartered in Easton, Maryland, serves as the Maryland QIO. DFMC is a nonprofit organization founded in 1973. DFMC's contract with the Federal Government is on a cost-plus-fixed-fee basis. DFMC's affiliate, Delmarva Foundation of the District of Columbia, assisted in performing the contracted activities for this SOW. We refer to both organizations in this report jointly as DFMC.

For the 3-year period known as the seventh SOW (November 1, 2002, through October 31, 2005), DFMC received $22.8 million in Federal reimbursement to perform the core contract and 14 special studies. For DFMC's FYs 2003 through 2005 (July 1, 2002, through June 30, 2005), it incurred total costs of approximately $81.3 million to support all lines of business, including the QIO contract.

Subsequent to our review, DFMC disclosed that DCAA reviewed DFMC accounting records; calculated indirect cost rates for FYs 2003, 2004, and 2005; and provided feedback to CMS. CMS issued final rates in October 2002 for FY 2003 and in October 2007 for FY 2004 and FY 2005. The rates for FY 2004 and FY 2005 did not include the unallowable indirect costs identified in this report and were adjusted as a result of our input. DCAA has not reviewed, nor has CMS provided any guidance concerning, the FY 2006 rates. However, DFMC unilaterally revised its FY 2006 rates to remove the disputed indirect costs. DFMC submitted revised vouchers that were computed using the adjusted rates for FYs 2004, 2005, and 2006. DFMC did not revise those vouchers that were computed with FY 2003 rates. As of April 3, 2008, the CMS contracting officer had yet to close out the contract for the seventh SOW. The CMS contracting officer will consider both DCAA and our audit work in establishing the final rates and settling the cost differences that occurred between the provisional and final rates for the seventh SOW.

Senate Finance Committee Request

The Senate Finance Committee requested that the Office of Inspector General review the fiscal integrity of the QIOs. The Senate Finance Committee requested that we review, at a minimum, the following areas:

1. board member and executive staff compensation;
2. board member and executive staff travel;
3. costs relating to legal fees, including administrative charges;

4. equipment and administrative charges;
5. business relationships and conflicts of interest; and
6. contract modifications.

The Senate Finance Committee also expressed concern about the extent to which QIOs addressed beneficiaries' quality of care concerns and the beneficiary complaint resolution process. We have examined that issue in another review (OEI 07-06-00170).

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

Our objective was to review the six fiscal integrity areas requested by the Senate Finance Committee.

Scope

We reviewed a judgmental sample of approximately $23.7 million of the costs that DFMC incurred during the seventh SOW (November 1, 2002, through October 31, 2005). In total, DFMC received $22.8 million in Federal reimbursement for the core QIO contract and 14 special studies.

The $23.7 million consisted of costs incurred for the six areas that the Senate Finance Committee requested we review. We reviewed these costs to determine whether they were (1) reasonable, allowable, and allocable under the terms of the contract and (2) supported by accounting records and other reliable documentation.

We limited our internal control review to DFMC systems and procedures for claiming costs to the extent necessary to accomplish our objective.

Our audit was intended to supplement information contained in DCAA audits of DFMC indirect cost rates.

We performed fieldwork at DFMC's offices in Easton, Maryland.

Methodology

We took the following actions to accomplish our objectives:

- We reviewed applicable Federal requirements.

- We interviewed DFMC officials and reviewed DFMC's policies and procedures to obtain an understanding of how it claimed costs for Federal reimbursement.

- We reviewed the provisions of the seventh SOW, including all modifications.

- We reviewed the records supporting the indirect cost pools to determine the reasonableness of the costs used to calculate the rates.

- We examined, on a test basis, evidence supporting $23.7 million of costs included in our review and incurred by DFMC. For each of the six areas reviewed, we identified the general ledger accounts that contained the expenses that DFMC incurred during the seventh SOW.

  - For board member compensation, we examined how frequently meetings were held, the rate used to pay the board members, and the number of board members who attended the meetings. For executive staff compensation, we examined each executive's W-2 form for the seventh SOW. CMS eliminated salary ceilings for QIO executives after the fifth SOW and no longer prescribes specific salary limitations. Accordingly, the general standards for reasonableness in executive salaries, as established by OMB Circular A-122, are applicable.

  - For board member and executive staff travel, we analyzed DFMC's vouchers to determine whether transportation costs of the board members and executive staff were reasonable and to determine whether the costs were allowable for Federal reimbursement.

  - For costs relating to legal fees, including administrative charges, we reviewed legal expenses for various services, including research and preparation of bid contracts and compensation issues, to determine whether the costs were reasonable and allowable for Federal reimbursement.

  - For equipment and administrative charges, we analyzed DFMC's inventory list of depreciable assets to determine whether the incurred costs were allowable for Federal reimbursement. We conducted a review of the listing of depreciable assets that included computers, printers, furniture, and other office equipment to determine whether equipment and administrative charges were reasonable. We identified costs to determine that they were properly allocated to the contract as indirect costs and verified indirect costs in equipment and depreciation accounts to the DFMC trial balance. We reviewed direct equipment costs.

  - For business relationships and conflicts of interest, we reviewed background information for DFMC Board of Directors, minutes from Board and Board subcommittee meetings, and subcontracts. We analyzed 57 DFMC subcontracts to determine whether the incurred costs were allowable for Federal reimbursement.

  - For contract modifications, we reviewed all 38 modifications to determine whether they increased the funding for the seventh SOW, added a special study, or were technical in nature. For modifications that added special studies, we reviewed the objectives of the studies to determine whether they were consistent with CMS's overall objectives for the seventh SOW.

- We reviewed DCAA working papers for its audit of DFMC costs claimed for FY 2003.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objective.

FINDING AND RECOMMENDATION

Of the $23.7 million of costs reviewed, $22.1 million appeared reasonable for Federal reimbursement. Of the remaining costs, DFMC incurred approximately $1.6 million of costs that were improperly classified as indirect costs. These costs were direct costs totaling $89,026 for recruiting that should have been charged to the QIO contract and rents and other costs totaling $1,548,509 attributable to specific contracts with State governments that should not have been included in the indirect costs. Because indirect costs are used to calculate the indirect cost rates, inflating these costs may have resulted in inflated indirect costs charged to this SOW.

IMPROPERLY CLASSIFIED COSTS

DFMC incurred a total of approximately $1.6 million of direct costs that were improperly classified as indirect costs.

Overstated Indirect Costs

According to OMB Circular A-122, Attachment A, section B.1, "[d]irect costs are those that can be identified specifically with a particular final cost objective, i.e., a particular award, project, service, or other direct activity of an organization." Attachment A, section C.1, identifies indirect costs as "those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective."

DFMC incorrectly included direct costs totaling $1,637,535 in an indirect cost pool. These costs were:

- $89,026 in recruiting costs that should have been recorded as direct charges to this QIO contract and

- $1,548,509 in rents and other costs (including an additional $7,973 in recruiting costs) that should have been recorded as direct costs to six other DFMC contracts, as required by OMB Circular A-122.

The indirect cost pools are used to calculate indirect cost rates for the contract. By overstating the indirect costs in the rate calculation, DFMC may have inflated indirect costs charged to this SOW.

We reviewed the advertising materials for which DFMC incurred recruiting costs of $89,026. These materials were specifically for recruiting employees to fulfill the QIO contract. Advertising materials resulting in additional costs of $7,973 were for recruiting employees to fulfill other identifiable cost objectives not related to the QIO contract.

During our review of rent costs, we found expenditures for facilities in California, Florida, Ohio, Vermont, and West Virginia. DFMC's controller informed us that these facilities supported contracts between DFMC and those State governments. At our request, the controller provided a listing of all costs associated with each facility. Based on the information provided, we concluded that these expenditures did not benefit the QIO contract. These should have been direct costs attributable to their specific State contracts and should not have been included in the indirect cost pool. DFMC had included these costs because it anticipated that, at some point, these facilities would benefit the QIO contract. Such a change in business practices would have supported the allocation of these expenditures as indirect costs. The change did not materialize, however, and DFMC failed to make the proper adjustments. The table below lists the direct costs that DFMC incorrectly included in the indirect cost pools, including $89,026 in recruiting costs that should have been recorded as a direct charge to the QIO contract.

Direct Costs Included in Indirect Costs

Costs	Fiscal Year				Total
	2003	2004	2005	2006	
Office Rent	$215,802	$324,123	$196,770	$163,331	**$900,026**
Telephone	79,857	62,863	29,969	55,046	**227,735**
Depreciation	61,878	53,172	45,197	37,301	**197,548**
Office Supplies	60,130	18,403	10,726	9,637	**98,896**
Recruiting	40,239	7,520	37,388	11,852	**96,999**
Utilities	9,564	10,526	7,759	10,763	**38,612**
Office Maintenance	8,464	22,763	3,630	3,494	**38,351**
Insurance	3,586	5,747	4,904	4,234	**18,471**
Travel	6,000	0	0	6,000	**12,000**
Consultant	0	7,179	0	275	**7,454**
Disposal	0	0	0	770	**770**
Furniture and Fixtures	0	0	0	673	**673**
Total	**$485,520**	**$512,296**	**$336,343**	**$303,376**	**$1,637,535**

RECOMMENDATION

We recommend that DFMC work with CMS to resolve the status of the $1,637,535 in questioned indirect costs as part of the final settlement of the SOW.

DELMARVA FOUNDATION FOR MEDICAL CARE'S COMMENTS AND OFFICE OF INSPECTOR GENERAL'S RESPONSE

In its comments on our draft report, DFMC did not specifically address the facts of our finding but took exception to our recommendation and offered five specific areas of disagreement with our representation of its accounting practices. However, DFMC stated that it changed its accounting practices as of July 1, 2007.

After reviewing DFMC's comments, we disagree with its interpretation of the criteria and continue to support our findings. We have modified our report by clarifying our data analysis. We also limited the recommendation to the QIO contract and recommended that DMFC resolve the questioned costs with CMS. We summarize and respond to DFMC's five reasons for taking exception to our report below. We have grouped the first two reasons into the section "Indirect Cost Rates" and the remaining three into the section "Accounting Treatment of Costs and Consistent Treatment of Costs." The Appendix presents DFMC's comments in their entirety, except for a 2-page attachment related to DCAA correspondence concerning FY 2003 indirect cost rates, which DFMC considers proprietary information.

Indirect Cost Rates

Delmarva Foundation for Medical Care's Comments

DFMC's first objection was to the inclusion in our finding of $485,520 for direct costs that were incorrectly included in the indirect cost pool in FY 2003. DFMC objected because DCAA had reviewed these costs and had issued a final rate letter on August 10, 2004. In addition, CMS had sanctioned the FY 2003 rates through a contract modification issued during the sixth SOW. Therefore, DFMC believes that FY 2003 costs were acceptable and should be removed from further discussion.

In its second objection, DFMC stated that it had charged facility-related expenses to indirect costs for several years and other Federal auditors had accepted this practice. DFMC believes that this report may lead readers to believe that this was an improper accounting practice.

Office of Inspector General's Response

The costs are not allowable because they are not allocable to the award under OMB Circular A-122, Attachment A, section A.4. The final rate letter and contract modification do not preclude the contracting officer from addressing allowable costs. Therefore, we have left the finding unchanged.

Costs that do not benefit the program, or benefit the program and other work, are not allocable to the program. During our audit, we identified costs for five facilities that benefited specific non-QIO contracts with the State governments and did not benefit the QIO contract. Therefore, these costs should not have been allocated to the QIO contract.

Accounting Treatment of Costs and Consistent Treatment of Costs

Delmarva Foundation for Medical Care's Comments

In its third objection, DFMC identified the costs that were included in the indirect cost pools as facility costs and stated that it normally records those costs as indirect costs in accordance with OMB Circular A-122.

In its fourth objection, DFMC stated that a retroactive change in its accounting practice would violate the requirement of OMB Circular A-122, Attachment A, section A.2, that costs be "accorded consistent treatment."

In its fifth objection, DFMC stated that modifying its accounting practice would violate cost accounting standards that require a cost accounting system to be consistent with the practice used in estimating and pricing its costs. As a result, DFMC stated that modifying its accounting practice may invalidate the cost basis used to negotiate the non-QIO contracts. However, DFMC stated it had changed its accounting practice for classifying indirect costs effective July 1, 2007.

Office of Inspector General's Response

DFMC correctly stated that OMB A-122, Attachment A, section C.2, identifies facility costs as a typical example of indirect costs. However, this example is subject to the requirement of Attachment A, section C.1, which defines indirect costs as "those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective." Attachment A, Section A.4, specifies that costs are allocable only if they are incurred specifically for the award or if they benefit both the award and other work and can be distributed in reasonable proportion to the benefits received. As noted on page 5, each of the facility costs identified in our review could be associated with a specific non-QIO contract. Therefore, the facility costs in question must be treated as direct costs of other (non-QIO) contracts.

As the report indicates, the costs that we identified should have been classified as direct costs in conformance with OMB Circular A-122, Attachment A, section B.1. These costs are not allowable because they are not allocable to the QIO award in accordance with Attachment A, section A.4. Only allowable and allocable costs may be included. Further, because CMS has not yet settled the status of the seventh SOW, the correction of the indirect cost amount used for computing indirect costs rates would not constitute a retroactive change.

Adjusting the indirect cost rates would not violate the consistency requirements of Cost Accounting Standards 401, "Consistency in Estimating, Accumulating, and Reporting Costs." This standard requires the use of the same cost accounting standards for proposing and claiming costs. The QIO proposal was developed using provisional indirect cost rates. The monthly vouchers used to claim costs were also calculated using provisional rates. Therefore, the treatment was consistent and will remain consistent even if the final cost rates are adjusted.

APPENDIX

Delmarva Foundation

December 11, 2007

RECEIVED
DEC 13 2007

Mr. Stephen Virbitsky
Regional Inspector General for Audit Services
Department of Health & Human Services
150 South Independence Mall West
Suite 316
Philadelphia, PA 19106-3499

Re: Audit Report Number A-03-06-01650 – Review of Quality Improvement Organization in Maryland

Dear Mr. Virbitsky:

We have reviewed the referenced draft audit report which you provided to us on September 17, 2007 and which was discussed during an exit conference on November 27, 2007. We greatly appreciate this opportunity to respond.

According to information contained in the draft report, the Senate Finance Committee requested that the Office of Inspector General (OIG) assess the fiscal integrity of the Quality Improvement Organizations (QIOs) and review at a minimum six specific areas which include (1) board member and executive staff compensation; (2) board member and executive staff travel; (3) costs relating to legal fees, including administrative charges; (4) equipment and administrative charges; (5) business relationships and conflicts of interest; and (6) contract modifications.

We are pleased to note from your draft report that OIG has not identified any reportable conditions in these six areas of prime interest by the Senate Finance Committee.

In your draft report, OIG takes exception to the way that Delmarva Foundation for Medical Care (DFMC) classified $1,637,535 of incurred costs during the four year period FY03-06. The costs at issue are primarily facility related including (1) office rent ($900,026); (2) telephone ($227,735); (3) depreciation ($197,548); (4) office supplies ($98,896); (5) utilities ($38,612); (6) office maintenance ($38,351); (7) insurance ($18,471); (8) disposal ($770); and (9) furniture and fixtures ($673). As explained in further detail below, we believe this section of the draft audit report omits some pertinent details and facts and thus leaves the impression that DFMC failed to properly account for these costs. Had these details and facts been presented, it would be clear that DFMC consistently followed cost accounting practices that had been approved by the Government and consistently followed cost accounting practices that are fully compliant with the cost principles in OMB Circular A-122 and Cost Accounting Standards (CAS).

During the four year period from FY03-06, DFMC accumulated all facility related expenses to the G&A expense pool which was then allocated to contracts based on Modified Total Direct Costs. In the current audit, OIG has recommended that facility costs be removed from the G&A pool and be allocated directly to contracts at those

9240 Centreville Road • Easton, MD 21601 • ph: 410.822.0697 • fax: 410.822.7971

District of Columbia Florida Maryland

assume that OIG believes these costs should remain in G&A and be allocated to all contracts based on Modified Total Direct Costs. We take exception to this section of the audit report for several reasons:

Firstly, the costs questioned include $485,520 from FY03. The Defense Contract Audit Agency (DCAA) concluded their FY03 incurred cost audit several years ago and a final rate letter was issued on August 10, 2004. A copy of the letter is attached. Subsequent to that audit, DFMC received a contract modification from the Centers for Medicare & Medicaid Services (CMS) to implement the audit determined rate structure on the Maryland QIO contract. As such, we believe that the costs attributed to FY03 were acceptable and are properly disregarded from further discussion.

Secondly, facility costs have been included in DFMC's G&A pool for many years and other federal auditors have accepted this practice. We believe these facts must also be illuminated so that the reader of the OIG report will understand the issue was not caused by any accounting impropriety by DFMC.

Thirdly, OMB Circular A-122, Attachment A, Sections C.2 and C.3 identifies facility costs as the types of expenses that are normally recorded as indirect costs.

Fourthly, implementing an accounting change retroactively would violate fundamental consistency requirements in Government regulations. For example, OMB Circular A-122, Attachment A, Section A.2 states that costs must be "accorded consistent treatment" to be allowable costs. It follows, then, that implementing accounting changes retroactively three or four years after the fact would directly conflict with this consistency requirement.

Finally, implementing a retroactive accounting change would conflict with the fundamental requirements of CAS 401, Consistency, in Estimating, Accumulating, and Reporting Costs. The fundamental requirement of CAS 401 is: "A contractor's cost accounting practices used in accumulating and reporting actual costs for a contract shall be consistent with his practices used in estimating costs in pricing the related proposal." Further, implementing these changes may invalidate the cost basis under which DFMC and our clients negotiated all contracts and change orders between FY04-06.

In summary, this audit identified $1,637,535 of incurred costs during the four year period of FY03 – FY06 which were scrutinized for assignment and allocation as indirect costs. These costs were principally related to facilities with a small component involving staff recruitment. We have presented information which demonstrates that the amount attributable to FY03 - $485,520 was legitimate based on an incurred cost audit by DCAA and validated with a contract modification from CMS to implement the audit determined rate structure. As such, we believe the amount in question is actually $1,152,015 and covers FY04 – FY06. We are continuing to gather information on recruiting costs that were accumulated in the G&A pool, but which could have been charged directly to the QIO contract. The other caveat to mention here is that this amount represents the total G&A pool, not the portion that was charged to CMS. Using the Modified Total Direct Cost method, these costs were allocated to numerous contracts in force during this period.

It is important to mention that we recently received a contract modification from CMS implementing a new rate structure for the Maryland QIO contract. We used this opportunity to make the aforementioned accounting changes prospectively, with an effective date of July 1, 2007. Further, we look forward to working with the Centers for Medicare & Medicaid Services in bringing these matters to a final resolution.

We appreciate the opportunity to work with you to achieve an outcome that is fair and reasonable for the Government and for DFMC.

Sincerely,

Christian E. Jensen MD

Christian E. Jensen, MD, MPH
President & CEO