

**Department of Health and Human Services**

**OFFICE OF  
INSPECTOR GENERAL**

**AUDIT OF MEDICARE  
ADMINISTRATIVE COSTS CLAIMED BY  
BLUE SHIELD OF CALIFORNIA FOR  
THE PERIOD OCTOBER 1, 1995  
THROUGH NOVEMBER 30, 1996**

*The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed, as well as other conclusions and recommendations in this report, represents the findings and opinions of the HHS/OIG Office of Audit Services. Final determination on these matters will be made by authorized officials.*



**JUNE GIBBS BROWN  
Inspector General**

**OCTOBER 1999  
CIN: A-09-98-00095**



CIN: A-09-98-00095

OCT - 1 1999

Karen Schievelbein  
Senior Vice President and Chief Financial Officer  
Blue Shield of California  
P.O. Box 7013  
San Francisco, California 94120

Dear Ms. Schievelbein:

Enclosed is the report covering the audit of administrative costs incurred under the Medicare program by Blue Shield of California, for the period October 1, 1995 through November 30, 1996.

Your attention is invited to the audit findings and recommendations on pages 2 through 5 of the report, which are summarized in Exhibit A to our report. The below named Health Care Financing Administration (HCFA) official will be communicating with you in the near future regarding implementation of recommendations. Should you have any questions or comments concerning these recommendations, please submit them to HCFA no later than 30 days from the date of this letter. If no comments are received by this date, HCFA will proceed with the initiation of the closing agreement. Your comments should be sent to:

Regional Administrator  
Health Care Financing Administration  
75 Hawthorn Street, 4<sup>th</sup> Floor  
San Francisco, California 94 105

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), OIG Office of Audit Services' reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act, which the Department chooses to exercise. (See Section 5.71 of the Department's Public Information Regulation, dated August 1974, as revised.)

To facilitate identification, please refer to Common Identification Number A-09-98-00095 in all correspondence relating to this report.

Sincerely,

A handwritten signature in black ink, appearing to read "Lawrence Frelot". The signature is written in a cursive, flowing style.

Lawrence Frelot  
Regional Inspector General  
for Audit Services

Enclosures

## EXECUTIVE SUMMARY

During the period October 1, 1995 through November 30, 1996, California Physicians' Service, dba Blue Shield of California (**BSC**) claimed administrative costs totaling **\$33,951,916**. The administrative costs charged to Medicare were overstated by \$234,378. The \$234,378 consisted of unreasonable increases in executive compensation costs (**\$60,230**), salaries over the Federal limit (**\$20,122**), unallowable consulting fees (**\$111,679**), legal fees (**\$29,418**), executive search fees (\$4,829) and understated complementary insurance credits (\$8,100). We are recommending that BSC reduce its Medicare claims for the \$234,378 in overstated costs.

We set aside pension costs of \$378,191, pending the resolution of Office of Inspector General audit report, dated April 1, 1999 (CIN: A-07-98-02523).

With the exception of our recommended adjustment of \$8,100 for the complementary insurance credit, BSC concurred with our audit findings. **BSC's** response is included in its entirety as Appendix A.

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## **INTRODUCTION**

### **BACKGROUND**

The Medicare program is a Federal health insurance program whose beneficiaries include persons 65 years of age or over, disabled or blind persons, or those suffering from chronic renal disorders. Medicare was established by Congress in 1965 through the enactment of Title XVIII of the Social Security Act. Medicare consists of two distinct parts. Hospital Insurance (Part A) covers expenses of medical services furnished in an institutional setting, such as a hospital or skilled nursing facility, or provided by a home health agency. Supplemental Medical Insurance (Part B) covers physician services, certain other Medical equipment and services, and other outpatient services.

The Medicare program is administered by the HCFA which contracted with BSC to receive, review, audit, and pay Medicare Part B claims. The BSC is entitled to reimbursement for the allowable administrative costs incurred, up to the contract ceiling, in carrying out its responsibilities under the program.

During the period October 1, 1995 through November 30, 1996, BSC processed 26,653,605 claims. The administrative costs reported by BSC for processing claims totaled \$33,951,916 for the 14-month period. The BSC did not renew its Medicare Part B contract which expired November 30, 1996.

### **SCOPE OF AUDIT**

Our audit was performed in accordance with generally accepted government auditing standards. The primary purpose of the audit was to express an opinion as to whether BSC's final administrative cost proposals (FACP) for the period October 1, 1995 through November 30, 1996 presented fairly the allowable costs of administration of the Medicare program in conformity with the reimbursement principles contained in the Federal Acquisition Regulations (FAR). Our audit did not include a review of BSC's pension costs.

In planning and performing our audit, we considered the internal control structure in order to determine our auditing procedures. This evaluation was for the purpose of expressing an opinion on the FACPs and not to provide assurance on the internal control structure.

The management of BSC is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgements by management are required to assess the expected benefits and related costs of an internal control structure. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition. Inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to

the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

The period covered by our audit was October 1, 1995 through November 30, 1996. The audit field work was conducted at BSC's San Francisco, California office during the period September 1998 through July 1999.

## **FINDINGS AND RECOMMENDATIONS**

### **Increases in Executive Compensation**

Federal regulations require that compensation charged to Medicare be reasonable (Section 3 1.205-6(b) of the FAR). Medicare program officials limit increases in executive compensation to increases in the Employment Cost Index (ECI) which is developed and published by the U.S. Department of Labor, Bureau of Labor Statistics to determine a reasonable rate of compensation increase.

Our prior report, CIN: A-09-96-00061 dated October 9, 1996, disclosed that compensation increases given to certain BSC executives during the review period October 1, 1992 through September 30, 1995 were higher than the increase in the ECI for the same period. The BSC concurred with the audit adjustment.

During our current review, we noted that three BSC executives had compensation increases that exceeded the ECI, which was 3.9 percent in CY 1996. The increases exceeded the ECI by \$1,317,423, of which \$60,230 was allocated to Medicare.

### **Recommendation**

We recommend that the FACPs be reduced by \$59,175 in FY 1996 and \$1,055 in FY 1997.

### **Auditee Response**

BSC concurred with the finding and recommendation.

### **Salaries Above Federal Limit**

Federal regulations (Section 3 1.205-6 (p) of the FAR) provide that FY 1997 costs for compensation of an officer in a senior management position that exceed \$250,000 per year are unallowable. The BSC had 3 employees who exceeded \$250,000 for FY 1997 and the amount overclaimed for the period October 1, 1996 through November 30, 1996 was \$20,122.

## **Recommendation**

We recommend that the FACP be reduced by \$20,122 in FY 1997.

## **Auditee Response**

BSC concurred with the finding and recommendation.

## **Consulting Fees**

The BSC allocated consulting fees which did not benefit the Medicare program. Section 3 1.201-4 of the FAR states in part: "A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship...." Management consulting costs and other professional fees related to unallowable activities, such as lobbying, review of adequacy of pay for sales staff and standard business projects unrelated to the Medicare program, are questioned in the amounts of \$111,489 in FY 1996 and \$190 in FY 1997.

## **Recommendation**

We recommend that BSC exclude \$111,489 and \$190 from the FACP for FYs 1996 and 1997.

## **Auditee Response**

BSC concurred with the finding and recommendation.

## **Legal Fees**

Section 3 1.205-47 (b) of the FAR states that "Costs incurred in connection with any proceeding brought by a Federal, State, local or foreign government for violation of, or a failure to comply with, law or regulation by the contractor (including its agents or employees) are unallowable if the result is (1) In a criminal proceeding, a conviction; (2) In a civil or administrative proceeding, either a finding of contractor liability where the proceeding involves an allegation of fraud or similar misconduct...."

Legal fees related to the defense of a civil lawsuit by the Federal government are questioned in the amounts of \$18,310 in FY 1996 and \$11,108 in FY 1997.

## **Recommendation**

We recommend that BSC exclude \$18,310 and \$11,108 from the FACP for FYs 1996 and 1997.



## **Auditee Response**

BSC concurred with the **finding** and recommendation.

## **Executive Search Fees**

Section 3 1.202(a) of the FAR states in part: “A direct cost is any cost that can be identified specifically with a particular final cost objective.... All costs specifically identified with other final cost objectives of the contractor are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly.”

We are questioning payments made to executive search firms for the employment of **non-**Medicare related personnel in the amount of \$4,829 for FY 1996. The BSC charged the costs of the executive searches for standard positions such as VP, Sales and Marketing, Senior Account Representative, Healthcare Consultant, and Director, Strategic Informatics to Medicare.

## **Recommendation**

We recommend that BSC exclude \$4,829 of unallocable executive search fees from the FACP for FY 1996.

## **Auditee Response**

BSC concurred with the finding and recommendation.

## **Complementary Insurance Credits**

The BSC understated the complementary insurance credit for FY 1997 by \$8,100. The HCFA approved rate for FY 1997 was \$.54 per claim, but BSC used a rate of \$.53 per claim.

## **Recommendation**

We recommend that BSC exclude \$8,100 from the FACP for FY 1997.

## **Auditee Response**

BSC disagreed with our finding. BSC stated that it credited Medicare \$791,647 for 1,318,996 claims transferred, or \$.60 per claim.

## **Auditor's Comment**

The Medicare credit of \$791,647 included a general BSC overhead credit of \$83,688. The \$83,688 was not related to complementary insurance.

### **Costs Set Aside**

The \$378,191 of pension costs were set aside pending the resolution of Office of Inspector General audit report, dated April 1, 1999 (CIN: A-07-98-02523), regarding BSC's pension costs for FYs 1991 through 1997.

### **OTHER MATTERS**

#### **Substitutable Costs**

In FY 1997, BSC overclaimed costs on the FACP by \$21,444. The approved budget for FY 1997 was \$4,973,300 and the amount claimed was \$4,994,744. Our review disclosed that these costs would be allowable and BSC can offset the \$21,444 against our audit adjustments.

### **RECOMMENDATIONS**

We recommend that BSC reduce the FACP for FY 1996 by \$193,803 and the FACP for FY 1997 by \$40,575.

**CALIFORNIA PHYSICIANS' SERVICES, SAN FRANCISCO  
DBA BLUE SHIELD OF CALIFORNIA  
SUMMARY OF RESULTS OF AUDIT  
OF MEDICARE ADMINISTRATIVE COSTS  
FOR THE PERIOD  
OCTOBER 1, 1995 THROUGH NOVEMBER 30, 1996**

	<u>Total</u>	<u>Recommended Costs</u>		
	<u>Prouosed</u>	<u>Adjustments</u>	<u>Set Aside</u>	<u>Notes</u>
Salaries and wages	\$12,017,619	\$ 80,352		1
Fringe benefits	3,565,981		\$378,191	2
Facilities or occupancy	2,288,868			
Subcontracts	10,827,467			
Outside professional services	1,216,705	145,926		3
Telephone and telegraph	695,417			
Postage	4,446,664			
Furniture and equipment	588,881			
Materials and supplies	1,293,057			
Travel	268,030			
Return of investment	74,665			
Miscellaneous	764,894			
Credit	<u>(4,096,332)</u>	<u>8,100</u>	<u>          </u>	4
<b>Total</b>	<u>\$33,951,916</u>	<u>\$234,378</u>	<u>\$378,191</u>	

Schedules 1 and 2 provide detail cost breakdowns by fiscal year.

**NOTES TO EXHIBIT A**

**Note 1.** The \$80,352 represents increases in executive compensation costs higher than the ECI (\$60,230) and salaries exceeding the Federal limit (\$20,122). The adjustments are discussed on page 2 of the report.

**Note 2.** The \$378,191 represents pension costs which we did not audit. See page 5 of the report.

**Note 3.** The \$145,926 represents unallowable consulting costs (\$111,679), legal fees (\$29,418) and executive search fees (\$4,829). The adjustments are discussed on pages 3 and 4 of the report.

**Note 4.** The \$8,100 represents understated complementary insurance credits. The adjustment is discussed on page 4 of the report.

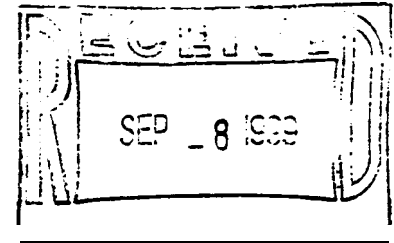
**CALIFORNIA PHYSICIANS' SERVICES, SAN FRANCISCO  
DBA BLUE SHIELD OF CALIFORNIA  
SUMMARY OF RESULTS OF AUDIT  
OF MEDICARE ADMINISTRATIVE COSTS  
FOR THE PERIOD  
OCTOBER 1, 1995 THROUGH SEPTEMBER 30, 1996**

	<u>Total Proposed</u>	<u>Recommended Costs Adjustments Set Aside</u>	
Salaries and wages	\$10,079,727	\$59,175	
Fringe benefits	3,129,946		\$359,869
Facilities or occupancy	1,986,443		
Subcontracts	9,207,878		
Outside professional services	1,099,261	134,628	
Telephone and telegraph	572,536		
Postage	3,687,336		
Furniture and equipment	537,034		
Materials and supplies	1,085,041		
Travel	246,395		
Return of investment	70,354		
Miscellaneous	559,906		
Credit	<u>(3,304,685)</u>	_____	_____
<b>Total</b>	<b><u>\$28,957,172</u></b>	<b><u>\$193,803</u></b>	<b><u>\$359,869</u></b>

**CALIFORNIA PHYSICIANS' SERVICES, SAN FRANCISCO  
DBA BLUE SHIELD OF CALIFORNIA  
S-Y OF RESULTS OF AUDIT  
OF MEDICARE ADMINISTRATIVE COSTS  
FOR THE PERIOD  
OCTOBER 1, 1996 THROUGH NOVEMBER 30, 1996**

	<u>Total</u> <u>Proposed</u>	<u>Recommended</u> <u>Adjustments Set Aside</u>	<u>Costs</u> <u>Set Aside</u>
Salaries and wages	\$1,937,892	\$ 21,177	
Fringe benefits	436,035		\$18,322
Facilities or occupancy	302,425		
Subcontracts	1,619,589		
Outside professional services	117,444	11,298	
Telephone and telegraph	122,881		
Postage	759,328		
Furniture and equipment	51,847		
Materials and supplies	208,016		
Travel	21,635		
Return of investment	4,311		
Miscellaneous	204,988		
Credit	<u>(791,647)</u>	<u>8.100</u>	<u>          </u>
Total	<u><b>3x,994.744</b></u>	<u><b>\$40.575</b></u>	<u><b>\$18.322</b></u>

APPENDIX A  
AUDITEE'S RESPONSE



September 7, 1999

Mr. Lawrence Frelot  
Regional Inspector General for Audit Services  
Office of Inspector General  
Department of Health & Human Services  
Region IX, Office of Audit Services  
50 United Nations Plaza  
San Francisco, CA 94102

Re: CIN A-09-98-00095

Dear Mr. Frelot:

Enclosed is Blue Shield of California's response to the U.S. Department of Health and Human Services, Office of the Inspector General, Office of Audit Services' draft report entitled "Audit of Medicare Administrative Costs Claimed, Blue Shield of California, for the period October 1, 1995 through November 30, 1996."

We understand that these comments will be considered in the process of finalizing your report.

If you have any questions, please contact Leslie Davis at (415) 229-5874.

Sincerely,

Karen Schievelbein  
Senior Vice President and  
Chief Financial Officer

enclosure

c: Kirk Sadur, HCFA



BLUE SHIELD OF CALIFORNIA

Carrier Response to Draft Audit Report  
Dated August 9, 1999

Audit of Medicare Administrative Costs Claimed,  
Blue Shield of California,  
For the Period  
October 1, 1995 through November 30, 1996

Increases in Executive Compensation

Blue Shield of California concurs with this finding in the amount of \$60,230.

Salaries Above Federal Limit

Blue Shield of California concurs with this finding in the amount of \$20,122.

Consulting Fees

Blue Shield of California concurs with this finding in the amount of \$ 111,679.

Legal Fees

Blue Shield of California concurs with this finding in the amount of 329,418.

Executive Search Fees

Blue Shield of California concurs with this finding in the amount of \$4,829.

Complementary Insurance Credits

Blue Shield of California disagrees with this finding in the amount of \$8,100. As detailed in the Credit Schedule of the 1997 FACP, Blue Shield of California credited Medicare \$791,647 for 1,318,996 claims transferred, or \$0.60 per claim. Therefore, our total credit claimed was \$0.06 per claim greater than required by HCFA, not \$0.01 lower. We recognize that the Credit Schedule reflects that we did not fully implement HCFA's crossover rate increase to each individual insurance company, however, we more than made up for the shortfall through a credit to general Blue Shield overhead. Across-the-board implementation of the new crossover rate, which would have effectively enabled Blue Shield to recoup these additional costs from external parties, was not feasible due to the fact that our contract only extended through two months of fiscal year 1997.

Other Matters

It should be noted that in addition to the \$2 1,444 of substitutable costs that should be offset against the final audit adjustments, Blue Shield of California intends to offset the total settlement amount by \$112,566, representing funding authorized by HCFA, but not received to date by Blue Shield. We have been unable to access this funding through the regular drawdown process for technical reasons.