

**Memorandum**

MAR - 2 2001

Date

*Michael Mangano*

From

Michael F. Mangano  
Acting Inspector General

Subject

Review of the Administrative Costs Included in the Calendar Year 2000 Adjusted  
Community Rate Proposal for a Florida Medicare Managed Care Risk Plan (A-04-00-02168)

To

Michael McMullan  
Acting Principal Deputy Administrator  
Health Care Financing Administration

Attached are two copies of our final report entitled, *Review of the Administrative Costs Included in the Calendar Year 2000 Adjusted Community Rate Proposal for a Florida Medicare Managed Care Risk Plan*. The report provides you with the results of our review of a managed care risk contractor (the Plan) in Florida.

The objective of our review was to evaluate the administrative cost component of the adjusted community rate proposal (ACRP) and to assess whether the costs were appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs.

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

However, based on the results of our audits at the nine MCOs, HCFA requested that the 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 ACRPs under the revised format. This review is in response to HCFA's request.

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<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)

As stated in our previous review, there is no statutory or regulatory authority governing allowability of costs in the revised ACR process, unlike other areas of the Medicare program. For example, regulations covering MCOs 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 MCO risk contracts.

Using reasonable cost guidelines, we identified \$13,107,786 in costs that could have been eliminated when computing the ACR if Federal Acquisition Regulations contract cost principles were applied to risk-based MCOs. The \$13,107,786 included:

- \$889,103 for such costs as travel and entertainment, alcoholic beverages, public relations, goodwill, contributions, unsupported costs, and costs that had no relation to the Medicare program.
- \$531,542 for public relations fees, radio and television announcements, video, printing, and courier services applicable to a private clinic not associated by ownership with the Plan.
- \$11,687,141 in excessive administrative costs allocated to Medicare as the result of the Plan using an unreasonable cost allocation methodology.

The effect of including these administrative costs in the Plan's ACRP 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. Using the resultant \$67.86 per member-per month rate reduction computed by eliminating these costs from the ACRP base year, we estimate that Medicare beneficiaries were adversely impacted in CY 2000 by about \$13.8 million (based on the Plan's projected Medicare enrollment levels). Adjusting the base year costs changes the relative cost ratios used to project the CY 2000 ACRP. The \$13.8 million could have been used to eliminate the premiums and copayments the Plan charged during CY 2000 or the Plan could have offered its enrolled Medicare beneficiaries additional benefits above those originally provided.

Because of a lack of criteria for inclusion of administrative costs on the ACRP, there are no recommendations addressed to the Plan. Despite the lack of specific guidelines for MCO risk-based contracts, we believe that those costs, that would not be allowable under other areas of the Medicare program, should be eliminated from the Medicare ACR calculation. The use of Medicare trust funds to pay the MCO's monthly capitation should not exceed an amount that would be incurred using existing regulations applied in other areas of the Medicare program. We believe the existing regulations include prudent and cost-conscious management concepts.

Plan officials disagreed with our finding regarding the allocation of administrative costs. They contended that allocating administrative costs to Medicare based on the number of enrollees did not take into account the higher administrative costs required to service Medicare enrollees. The Plan also included a general comment about the basic premise of Medicare risk contracting, which did not specifically address the audit findings.

The Medicare ACR process is designed for MCOs to present to HCFA their estimate of funds needed to cover the costs of providing the Medicare package of covered services. Without specific cost standards and criteria, we do not believe HCFA can properly evaluate the proposals.

We do not disagree with the Plan's position that certain administrative costs such as claims processing are higher for Medicare enrollees versus commercial enrollees. However, the Plan did not provide any detailed documentation to support the reasonableness of its revenue-based cost allocation. We believe that the revenue-based allocation formula resulted in a disproportionate share of administration costs being allocated to Medicare.

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 call 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-04-00-02168 in all correspondence relating to this report.

Attachment

**Department of Health and Human Services**

**OFFICE OF  
INSPECTOR GENERAL**

**REVIEW OF THE ADMINISTRATIVE  
COSTS INCLUDED IN THE CALENDAR  
YEAR 2000 ADJUSTED COMMUNITY  
RATE PROPOSAL FOR A FLORIDA  
MEDICARE MANAGED CARE  
RISK PLAN**



**MARCH 2001  
A-04-00-02168**

**Memorandum**

MAR - 2 2001

Date *Michael Mangano*  
From Michael F. Mangano  
Acting Inspector General

Subject Review of the Administrative Costs Included in the Calendar Year 2000 Adjusted  
Community Rate Proposal for a Florida Medicare Managed Care Risk Plan (A-04-00-02168)

To Michael McMullan  
Acting Principal Deputy Administrator  
Health Care Financing Administration

This final report provides you with the results of our review of the administrative costs included in the adjusted community rate proposal (ACRP) submitted to the Health Care Financing Administration (HCFA) for Calendar Year (CY) 2000 by a managed care risk contractor (the Plan) in Florida. The objective of our review was to evaluate the administrative cost component of the ACR proposal and to assess whether the costs were appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs.

In an Office of Inspector General (OIG) audit report issued in January 2000,<sup>1</sup> we identified \$66.3 million of administrative costs that were included in the ACRPs submitted by nine managed care organizations (MCO) that 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 risk-based MCOs to follow Medicare's general principle of paying only reasonable costs. The HCFA did not concur with the recommendation. The HCFA noted that it had recently revised the adjusted community rate (ACR) methodology and that the new procedures will be reviewed to ensure the effectiveness of reducing the administrative burdens on the MCO.

However, based on the results of our audits at the nine MCOs, HCFA requested that the 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 ACRPs under the revised format. This review is in response to HCFA's request.

As stated in our previous review, there is no statutory or regulatory authority governing allowability of costs in the ACR process, unlike other areas of the Medicare program. For example, regulations covering MCOs that contract with HCFA on a cost reimbursement

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<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)

basis provide specific parameters delineating allowable administrative costs for enrollment and marketing. These same guidelines, however, are not used in administering the MCO risk contracts.

Using reasonable cost guidelines, we identified \$13,107,786 in costs that could have been eliminated when computing the ACR if Federal Acquisition Regulations (FAR) contract cost principles were applied to risk-based MCOs. The \$13,107,786 included:

- \$889,103 for such costs as travel and entertainment, alcoholic beverages, public relations, goodwill, contributions, unsupported costs, and costs that had no relation to the Medicare program.
- \$531,542 for public relations fees, radio and television announcements, video, printing, and courier services applicable to a private clinic not associated by ownership with the Plan.
- \$11,687,141 in excessive administrative costs allocated to Medicare as the result of the Plan using an unreasonable cost allocation methodology.

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. Using the resultant \$67.86 per member-per month rate reduction computed by eliminating these costs from the ACRP base year, we estimate that Medicare beneficiaries were adversely impacted in CY 2000 by about \$13.8 million (based on the Plan's projected Medicare enrollment levels). Adjusting the base year costs changes the relative cost ratios used to project the CY 2000 ACRP. The \$13.8 million could have been used to eliminate the premiums and copayments the Plan charged during CY 2000 or the Plan could have offered its enrolled Medicare beneficiaries additional benefits above those originally provided.

Because of a lack of criteria for inclusion of administrative costs on the ACR proposal, there are no recommendations addressed to the Plan. This audit is part of a nationwide review of the ACR process and is being performed at several other MCOs. Based on the results of the individual reviews, we will be making recommendations to HCFA.

Plan officials disagreed with our finding regarding the allocation of administrative costs. They contended that allocating administrative costs to Medicare based on the number of enrollees did not take into account the higher administrative costs required to service Medicare enrollees. The Plan also included a general comment about the basic premise of Medicare risk contracting, which did not specifically address the audit findings. The Plan's complete response to our report is included as Appendix A.

We do not disagree with the Plan's position that certain administrative costs such as claims processing are higher for Medicare enrollees versus commercial enrollees. However, the Plan did not provide any detailed documentation to support the reasonableness of its revenue-based cost allocation. We believe that the revenue-based allocation formula resulted in a disproportionate share of administration costs being allocated to Medicare.

While this review examined only one plan, we believe that our 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 six 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.

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## INTRODUCTION

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### BACKGROUND

Medicare payments to risk-based MCOs are based on a prepaid capitation rate. The rate reflects the estimated costs that would have been incurred by Medicare on behalf of enrollees of the MCO if they received their covered services under Medicare fee-for-service. Risk contractors are required by section 1876 of the Social Security Act to compute an ACR proposal and submit it to HCFA prior to the beginning of the MCO's contract period. The HCFA encourages the providers to support their ACR proposal with the most current data available. The Medicare ACR process is designed for MCOs to present to HCFA their estimate of the funds needed to cover the costs (both medical and administrative) of providing the Medicare package of covered services to any enrolled Medicare beneficiary.

The MCO calculates its ACR based on its commercial rates adjusted to account for differences in cost and use of services between Medicare and commercial enrollees. If the average Medicare payment rate (estimated monthly capitation received from HCFA) is greater than the ACR, an excess amount is noted. The MCO is required to use this "excess" to either improve their benefit package to the Medicare enrollees, reduce the Medicare enrollee's premium, or contribute to a benefit stabilization fund.

As a result of the Balanced Budget Act of 1997 (Public Law 105-33), administrative costs are determined using a relative cost ratio based on actual administrative costs incurred for Medicare beneficiaries in a base year to actual administrative costs incurred for non-Medicare enrollees in the same base year. However, the HCFA guidelines do not require that MCOs adhere to cost principles that preclude the reporting of unreasonable, unnecessary, and/or unallocable administrative costs.

With regard to the inclusion of costs, according to the MCO manual, all assumptions, cost data, revenue requirements, and other elements used by the MCOs in the ACR calculations must be consistent with the calculations used for the premiums charged to non-Medicare enrollees.

## **OBJECTIVE, SCOPE, AND METHODOLOGY**

The objective of our review was to evaluate the Plan's administrative cost component of the CY 2000 ACR proposal and assess whether the costs were appropriate when considered in light of the Medicare general principle of paying only reasonable costs.

Our review was conducted in accordance with generally accepted government auditing standards. To accomplish our objective, we interviewed Plan officials to obtain an understanding of how the administrative costs were derived. We also reviewed the Plan's 1998 financial records used to support the 2000 ACR proposal.

Our review of Medicare administrative costs included selecting costs from the Plan's general ledger and tracing the costs to paid invoices, journal entries, and any other documentation provided to support the costs. We reviewed each cost using the guidelines HCFA applies to cost-based MCOs and Medicare fee-for-service carriers, intermediaries, and providers. In addition, we reviewed the reasonableness of the Plan's methodology for allocating administrative costs to Medicare.

Our audit objective did not require us to test the internal control structure of the Plan. Due to the limited scope of the audit, the results cannot be considered representative of the universe of the administrative costs submitted by the Plan.

Our field work was conducted at the Plan's office. We discussed our findings with Plan officials to the extent necessary to satisfy ourselves as to the validity and accuracy of our conclusions.

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## **RESULTS OF REVIEW**

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Our review identified \$13,107,786 in costs allocated to Medicare that may not have been appropriate when compared to the Medicare program's general principle of paying only reasonable costs.



### **Travel, Entertainment, and Alcoholic Beverages**

We identified \$284,825 that was allocated to Medicare for costs applicable to stadium sky boxes, tickets for sporting events, concert tickets, sponsorships and participation at golf tournaments, meals and alcoholic beverages served by caterers and restaurants, and lodging for seminars and conferences not related to Medicare.

The FAR, subchapter E, section 31.205-14, Entertainment Costs, states that, "Costs of amusement, diversions, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities are unallowable... Costs of membership in social, dining, or country clubs or other organizations having the same purposes are also unallowable, regardless of whether the cost is reported as taxable income to the employees." Further, the FAR, section 31.205.51 states that "costs of alcoholic beverages are unallowable."

### **Public Relations, Contributions, and Donations**

We identified \$27,804 that was allocated to Medicare, representing donations to various civic organizations, sun visors for a picnic, and memberships and dues for events not related to Medicare.

Regarding such costs, the FAR section 31.205-1(a)(5)(f) states that, "Unallowable public relations and advertising costs include...costs of sponsoring meetings, conventions, symposia, seminars, and other special events when the principal purpose of the event is other than dissemination of technical information...." Also disallowed are "costs of promotional material...to call favorable attention to the contractor and its activities" and "costs of memberships in civic and community organizations." Further, section 31.205-8 states that "contributions or donations, including cash, property and services, regardless of recipient, are unallowable..."

### **Goodwill**

We identified \$65,180 allocated to Medicare representing amortization of goodwill. According to the FAR section 31.205-49 "Any costs for amortization...of goodwill (however represented) are unallowable."

### **Unsupported Costs**

We identified \$387,078 in costs allocated to Medicare which were not adequately supported by Plan records. We requested but were not provided documentation to support the costs reported on the accounting records. These costs represented a variety of administrative costs including contract personnel costs, legal and consulting fees, memberships and dues in

various organizations, travel and other employee expenses, advertising, investment services, and network management costs. In the absence of adequate documentation to support the costs, we could not determine if the costs were reasonable.

The FAR section 31.201-2 states that contractors are responsible for accounting for costs appropriately and for maintaining adequate supporting documentation to demonstrate that costs claimed are allocable and comply with applicable cost principles.

#### **Costs Not Related to Medicare**

We identified \$124,216 in various costs allocated to Medicare that had no relationship to the Medicare program. This total primarily represented legal fees and investment service costs. To be allowable, costs should be allocable to the Medicare program, and these costs would not be allocable under Medicare cost principles. The FAR section 31.201-2 states that contractors are responsible for accounting for costs appropriately and for maintaining adequate supporting documentation to demonstrate that costs claimed are allocable.

#### **Marketing Costs for a Private Clinic**

We identified \$531,542 in costs allocated to Medicare applicable to a private clinic not related by ownership to the Plan. The \$531,542 represented costs for public relations, radio and television announcements, video, printing, and courier services of the clinic, a separate private entity. Plan officials claimed that the costs were necessary to market their services to potential Medicare enrollees.

The FAR section 31.205-1, Public Relations and Advertising Costs, states that unallowable public relations and advertising costs include "...all public relations and advertising costs...whose primary purpose is to promote the sale of...services by stimulating interest in a product...or by disseminating messages calling favorable attention to the contractor for purposes of enhancing the company image to sell the company's products or services."

In addition to paying these types of costs on behalf of the clinic, the Plan also paid a fee to the clinic for patient referrals. In Fiscal Year 2000, the Plan paid \$1,060,731 to the clinic in the form of patient referral fees. These fees should have been more than adequate to compensate the clinic, and we found no reason for the Plan to pay an additional \$531,542 towards marketing costs.

#### **Excessive Administrative Cost Allocation**

We identified \$11,687,141 in excess administrative costs allocated to Medicare as a result of the allocation methodology used by the Plan. The Plan allocated administrative costs to Medicare using a ratio of Medicare revenues to total revenues. With some adjustments, on average the Plan allocated 28 percent of marketing costs to Medicare (about \$12.6 million),

and 42 percent of all other administrative costs to Medicare (about \$35 million). In our opinion, this methodology resulted in excessive cost allocations to Medicare, because revenues do not equitably represent the distribution of the administrative workload.

Title 42 CFR 417.564(a), Apportionment and Allocation of Administrative and General Costs for cost-based plans states that, "Enrollment, marketing, and other administrative and general costs that benefit the total enrollment of the HMO or CMP and are not directly associated with furnishing medical care must be apportioned on the basis of a ratio of Medicare enrollees to the total HMO or CMP enrollment."

We believe a more equitable cost allocation would be based on the number of enrollees in each line of business. Using enrollees as a basis, Medicare would have been allocated only 13 percent of the Plan's administrative costs, instead of 28 percent or 42 percent. By using what we believe to be an unreasonable allocation methodology, Medicare was allocated \$11,687,141 in excessive administrative costs.

Plan officials explained to us that it was reasonable to use Medicare revenues rather than Medicare enrollees because it cost more to process a Medicare beneficiary than a commercial enrollee. The officials said that using a percentage of Medicare revenues and applying it to the administrative cost of operations was more representative of the cost incurred to process a Medicare member.

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

Our review of the 2000 ACR proposal showed that about \$13.1 million in base year administrative costs would have been unallowable or unsupported had the Plan been required to follow Medicare's general principle of paying only reasonable costs. Adjusting the base year costs changes the relative cost ratios used to project the CY 2000 ACRP. As a result, we calculated that these adjustments would have reduced the administrative costs reported in the 2000 ACR by \$67.86 per member-per month, or about \$13.8 million based on the Plan's projected Medicare enrollment levels.

### **CONCLUSION AND RECOMMENDATIONS**

Our review showed that certain administrative costs included in the Plan's administrative cost component of the ACR proposal were not appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs. We question whether many of these costs should be included in the Plan's ACR proposal, since it only serves to increase the administrative costs for CY 2000. This affects the computation of potential "excess" from the Medicare payment amounts, and ultimately adversely impacts the amount available to Medicare beneficiaries for additional benefits or reduced premiums.

Using the resultant \$67.86 per member-per month rate reduction computed by eliminating these costs from the ACR proposal, we estimate that Medicare beneficiaries were adversely impacted in CY 2000 by about \$13.8 million. The \$13.8 million could have been used to eliminate the premiums and copayments the Plan charged during CY 2000 or the Plan could have offered its enrolled Medicare beneficiaries additional benefits above those originally provided.

We recognize that currently there is no statutory or regulatory authority governing the allowability and reasonableness of administrative costs in the ACR process, unlike other areas of the Medicare program. Notwithstanding the lack of specific guidelines for MCO risk-based contracts, we believe that those costs that would not be allowable under other areas of the Medicare program should be eliminated from the Medicare ACR calculation. The use of Medicare trust funds to pay the MCOs' monthly capitation should not exceed an amount that would be incurred using existing regulations applied in other areas of the Medicare program that we believe include prudent and cost-conscious management concepts.

While this review examined only one plan, we believe that our 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 six 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.

#### **PLAN'S COMMENTS**

Plan officials disagreed with our finding regarding the allocation of administrative costs. They contended that Medicare enrollees have on average more than three times as many claims as commercial enrollees and that therefore it is unfair to allocate administrative costs to Medicare based on the number of enrollees. They argued that higher claims volume translates into higher claims processing costs for Medicare enrollees. The Plan also added a general comment about the basic premise of Medicare risk contracting, which did not specifically address the audit findings. See Appendix A for the full text of the Plan's comments.

#### **OIG'S RESPONSE**

The Medicare ACR process is designed for MCOs to present to HCFA their estimate of funds needed to cover the costs of providing the Medicare package of covered services. Without specific cost standards and criteria, HCFA cannot properly evaluate the proposals.

We do not disagree with the Plan's position that certain administrative costs such as claims processing are higher for Medicare enrollees versus commercial enrollees. However, the

Plan did not provide any detailed documentation to support the reasonableness of its revenue-based cost allocation. Although we agree with the Plan's premise that certain indirect costs are higher for Medicare enrollees versus commercial enrollees, we believe that the revenue-based allocation formula resulted in a disproportionate share of administration costs being allocated to Medicare.

OIG NOTE: All information identifying the name and address of the Florida MCO was deleted from the MCO's response.

APPENDIX A

October 13, 2000

Mr. Peter Barbera  
Department of Health & Human Services  
Region IV, Room 3T41  
61 Forsyth Street, S.W.  
Atlanta, Georgia 30303-8909

RE: CIN - A-04-00-02168

Dear Mr. Barbera:

Pursuant to Mr. Charles Curtis' letter dated September 29, 2000 with regards to the 2000 Adjusted Community Rate Proposal Audit, we are submitting the following responses:

We respectfully disagree with the calculations and conclusions presented in the report.

#### Excessive Administrative Cost Allocation

We believe that allocating costs to Medicare based on number of enrollees does not adequately recognize the higher utilization of administrative resources by Medicare members. For example, the average Medicare enrollee has over three times as many medical claims as a commercial member. This translates into greater claims processing cost per month for Medicare enrollees. Similar situations occur for most administrative costs. The plan had chosen to not spend administrative resources to develop sophisticated cost allocation models to provide cost allocations since they were not required under the Medicare risk contract model. It is our belief that if current regulations change to require this sophistication, the allocation of administrative cost to Medicare will turn out to show similar results to those achieved by using premium as an allocation method.

#### General Comment

We believe the goal of the audit misses entirely the basic premise of Medicare risk contracting. Plans enter into the risk program because they believe that on an overall basis they can provide beneficiaries with services greater than the beneficiary would receive from traditional Medicare at a cost that allows the plan to make a reasonable return on its investment. The payment mechanism initially proposed (95% of AAPCC) should provide an adequate pool of revenue for the plans to work with. Subsequent changes in funding and Medicare mandated services have made it very difficult for plans to continue to participate. The adding of additional administrative cost to provide data not currently required or needed will only diminish the available pool of plans willing to participate in the program. This will lessen the choices of Medicare beneficiaries. Instead of reducing the cost to Medicare, overall costs will rise.

Please call me at \_\_\_\_\_ if you have any questions or require additional information.

Sincerely,