

**Department of Health and Human Services**

**OFFICE OF  
INSPECTOR GENERAL**

**KING COUNTY MEDICAL BLUE SHIELD  
SEATTLE, WASHINGTON**

**AUDIT OF TERMINATION COSTS  
CLAIMED UNDER MEDICARE  
CONTRACT NO. HCFA 90-045-2**



**JUNE GIBBS BROWN  
Inspector General**

**NOVEMBER 1995  
CIN: A-10-95-00003**



Office of Audit Services  
Region IX  
50 United Nations Plaza  
Room 171  
San Francisco, CA 94102

November 27, 1995  
CIN: A-1 O-95-00003

Mr. Edward C. Freutel  
Vice President, Government Programs  
King County Medical Blue Shield  
1800 Ninth Avenue, P.O. Box 21267  
Seattle, Washington 98 111-3267

Dear Mr. Freutel:

This letter represents the final report on the results of our audit of termination costs claimed by King County Medical Blue Shield (KCMBS) under Medicare Contract No. HCFA 90-045-2 for the period January 1, 1994 through December 31, 1994. Of the \$1,895,823 claimed for termination costs, we determined that \$1,345,962 was acceptable for reimbursement and questioned \$539,021. We did not audit \$10,840 claimed for pension costs because those costs are under review by Office of Audit Services staff in Kansas City, Missouri (Region VII).

## INTRODUCTION

### BACKGROUND

Overall responsibility for the administration of the Medicare program resides with the Secretary of Health and Human Services (HHS). Within HHS, this responsibility has been assigned to the Health Care Financing Administration (HCFA). In accordance with Title XVIII of the Social Security Act, as amended, HCFA contracts with private insurers to process Medicare claims and make benefit payments on behalf of the Government.

Effective October 1, 1990, HCFA contracted with KCMBS to perform services as the Medicare Part B carrier for the State of Washington. The contract ended September 30, 1993 upon HCFA's decision not to renew the contract and to select another company to serve as the Part B carrier for Washington. A 3-month period, October 1, 1993 through December 31, 1993, was provided as a period of transition to the successor contractor.

Final Medicare administrative cost proposals submitted by KCMBS for the period October 1, 1990 through December 31, 1993 have previously been audited by Conrad & Associates,

Certified Public Accountants, under a contract awarded by the Office of Inspector General, Office of Audit Services.

For the period January 1, 1994 through December 31, 1994, KCMBS was allowed to be reimbursed for certain costs incurred in connection with termination of the contract. The limitations on allowable costs were included in a letter from HCFA, dated December 22, 1993. Our audit of the costs claimed, totalling \$1,895,823, was made at the request of HCFA.

## SCOPE

The audit was conducted in accordance with generally accepted government auditing standards. Our objective was to determine whether termination costs (excluding pension costs) claimed for the period January 1, 1994 through December 31, 1994 were allowable in accordance with the Medicare contract, applicable rules and regulations, and/or prior agreement with HCFA, and were supported by verifiable documentation. A separate audit of pension costs is being performed by Office of Audit Services staff in Kansas City, Missouri (Region VII).

We performed such tests of the accounting records and other auditing procedures as were considered necessary to meet our objective. In addition, we reviewed the personnel files for selected KCMBS terminated employees as deemed necessary.

We also reviewed the audit report of Conrad & Associates on KCMBS's Medicare final administrative cost proposals for the period October 30, 1990 through December 31, 1993. Our field work was performed in Seattle, Washington at the offices of KCMBS and at HCFA, Region X during April through June 1995.

## RESULTS OF AUDIT

The results of audit are summarized below and presented in detail in the EXHIBIT.

Costs Claimed	<u>\$1,895,823</u>
Results of Audit:	
Costs Considered Acceptable	<u>\$1,345,962</u>
Costs Questioned	<u>\$ 539,021</u>
Costs Not Audited	<u>\$ 10,840</u>

On September 20, 1995, KCMBS provided a written response to the findings in our draft report. We have summarized KCMBS's comments in the notes to the EXHIBIT. A copy of the response is presented in the APPENDIX.

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In accordance with the principles of the Freedom of Information Act (Public Law 90-23), Office of Inspector General, 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 45 CFR Part 5.)

Final determination as to actions taken on all matters reported will be made by the HCFA action official named below. We request that you respond to the HCFA 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. To facilitate identification, please refer to the Common Identification Number A-10-95-00003 in all correspondence relating to this report.

Sincerely,



Lawrence Frelot  
Regional Inspector General  
for Audit Services

Attachments:  
EXHIBIT  
APPENDIX

**Direct Reply to HCFA Action Official:**

Mr. John Koziol  
Deputy Regional Administrator  
Health Care Financing Administration, Region X  
U.S. Department of Health and Human Services  
2201 Sixth Avenue, M/S RX-40  
Seattle, Washington 98 12 1

**KING COUNTY MEDICAL BLUE SHIELD**  
**SEATTLE, WASHINGTON**  
**SCHEDULE OF TERMINATION COSTS CLAIMED**  
**UNDER MEDICARE CONTRACT NO. HCFA-90-045-2**  
**AND RESULTS OF AUDIT**  
**FOR THE PERIOD**  
**JANUARY 1, 1994 THROUGH DECEMBER 31, 1994**

<b>Cost Categories</b>	<b>costs Claimed</b>	<b>costs Considered Acceptable</b>	<b>costs Questioned</b>	<b>Costs Not Audited</b>	<b>Note</b>
Continuing Activity Costs	\$ 351,736	\$ 235,099	\$ 105,797	\$ 10,840	1
Severance and Incentive Costs	1,043,828	832,839	210,989	0	2
Facilities Costs	264,613	163,916	100,697	0	3
Professional Fees	112,184	5,000	107,184	0	4
Bureau Costs	123,462	109,108	14,354	0	5
Totals	\$ 1,895,823	\$ 1,345,962	\$ 539,021	\$ 10,840	

The referenced notes are found on pages 2 through 8 of this EXHIBIT and are an integral part of this report.

**Note 1 - Continuing Activity Costs.** The continuing activity costs claimed of \$351,736 included direct and indirect costs of the electronic data interchange (EDI), financial analysis, and Medicare departments, and of operating the Part B Medicare Automated Claim System. We determined that there was adequate support for the allocability, allowability, and reasonableness of \$235,099 in continuing activity costs. We did not audit the \$10,840 in pension costs claimed because these costs are being audited by staff from Region VII of the Office of Audit Services. The amount questioned of \$105,797 represents costs claimed that are not allowable for reimbursement by Medicare consisting of the following:

- ▶ ED1 Costs - \$47,610. The HCFA set a limit on the amount of ED1 department salaries that could be claimed for reimbursement. The \$47,610 represents costs claimed in excess of the limit approved by HCFA, including the applicable departmental overhead.
- ▶ Legal Settlement - \$11,000. A legal settlement cost of \$11,000 was claimed which was not reimbursable under Federal regulations. The 48 CFR 31.205-47(d) provides that costs incurred in connection with any legal proceeding may be allowable when it is determined that the costs were incurred as a direct result of a specific term or condition of a Federal contract. The settlement was not a 'direct result of specific contract terms, but of the contract termination in general. A KCMBS official stated that the costs were claimed in error.
- ▶ Retirement Benefits - \$8,059. The \$8,059 in unallowable retirement benefits includes \$3,746 for post retirement benefits that had not been funded and \$4,313 for executive retirement benefits that were not supported. The 48 CFR 31.205-6 requires that for post retirement benefits other than pension costs to be allowable, the recorded actuarial liability must be funded. The KCMBS has decided not to fund the actuarial liability for post retirement benefits. In addition, KCMBS was unable to provide us with documentation supporting \$4,313 in executive retirement benefits claimed.
- ▶ Depreciation - \$3,430. Depreciation in the amount of \$3,430 was claimed in error. The error was subsequently found by KCMBS, but no adjustment was made to the costs claimed.
- ▶ General and Administrative Expenses - \$35,698. We have questioned \$35,698 of general and administrative expenses claimed, consisting of (i) \$16,553 related to unallowable ED1 costs claimed and (ii) \$19,145 related to other cost centers for which direct costs were appropriately excluded by KCMBS from the claim for reimbursement.

### **KCMBS Comments**

The KCMBS stated that costs proposed to HCFA for ED1 activity were estimates, and that the amount of costs claimed was the result of allocating the total costs incurred by the ED1 department. The allocation basis was the number of claims received by each line of business. The KCMBS believes that it should be reimbursed for the total costs incurred for this activity and implied that there was no limit imposed by HCFA for this activity.

In addition, KCMBS took exception to the questioned general and administrative expenses related to the questioned ED1 costs. The basis for the KCMBS position was since it believed that the ED1 costs should be reimbursed, the associated general and administrative costs should also be reimbursed. The KCMBS did not take exception to the remaining continuing activity findings.

A copy of the KCMBS written response to our draft report is presented in the APPENDIX.

### **OIG Response**

We agree that the costs proposed for ED1 activity were estimates submitted to HCFA by KCMBS. However, after the cost proposal was submitted, a conference call was held between HCFA and KCMBS to discuss the costs proposed for EDI activity. A HCFA record of the conference call indicated that the amount proposed for ED1 salaries was the amount approved. Other internal HCFA documents showed that HCFA had informed KCMBS that reimbursement for EDI salaries was limited to the approved amount.

Further, KCMBS recognized this limitation in vouchers submitted by specifically subtracting EDI costs in excess of the approved amount. The adjustments on the vouchers were identified as "Adjustment for EDI Budget Cap." On the final voucher for termination costs submitted in March 1995, KCMBS retroactively claimed those costs incurred over the limit.

Accordingly, we determined that the \$47,610 in EDI costs that exceeded the limitation stipulated by HCFA, and the related general and administrative costs of \$16,553, were not reimbursable.

**Note 2 - Severance and Incentive Costs.** We determined that \$832,839 of the \$1,043,828 claimed as severance and incentive pay was adequately supported as to allocability, allowability, and reasonableness. The eligibility of employees for incentive payments was also adequately supported. However, the remaining \$210,989 is questioned as unallowable for Medicare reimbursement. This amount includes:

- ▶ Management Incentive Pay - \$114,234. Initially, KCMBS officials properly excluded \$114,234 of management incentive pay from the claimed costs, but then included it on the final voucher. This amount exceeded the 6 weeks of incentive pay for managers and supervisors approved by HCFA.
- ▶ Release Agreements - \$32,966. The KCMBS claimed \$32,966 for payments to certain employees for providing signed release agreements. Although the payments were made in accordance with the KCMBS severance policy and claimed as severance pay, the costs were specifically excluded by HCFA from reimbursement as severance pay. Further, the entire amount exceeded the severance pay amount approved by HCFA.
- ▶ Severance Pay Not Allocable - \$3 1,343. We found that \$3 1,343 in severance pay was not allocable to Medicare. As provided in 48 CFR 3 1.20 1-4(b), a cost is allocable to a

government contract if it benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received. For a KCMBS employee with service time documented in both the Medicare department and other lines of business within KCMBS, the severance pay should be allocated to Medicare in proportion to the time worked on the Medicare program.

Initially, KCMBS officials excluded \$20,512 from the claimed costs to reflect the time that employees worked on other lines of business. Later, they included that amount on the final voucher because they did not agree with the requirement to prorate severance pay.

In addition, we identified \$10,831 for other employees whose service was not 100 percent Medicare. Two of the employees were assigned to a project for which the KCMBS Medicare contract, under agreement with HCFA, was not to bear any costs. Others worked in the private lines of business of another organization prior to its merger with KCMBS in October 1989.

- ▶ **Outplacement Costs - \$29,623.** Of the \$29,623 claimed as outplacement costs, \$19,118 was for consultant services unrelated to Medicare. A KCMBS official stated that these costs were claimed in error. The remaining \$10,505 was claimed for outplacement services provided to terminated KCMBS employees. The incentive pay package approved by HCFA specifically excluded costs for outplacement services.
- ▶ **Errors in Calculation - \$2,823.** We found two errors in the calculation of severance and incentive pay totalling \$2,823. The KCMBS policy was that a partial year of service should not be rounded up unless it was within 30 days of the service date. For one employee, the number of years of service was inappropriately rounded up. For a second employee, the severance and incentive pay calculations were made using a salary amount greater than the recorded annual salary at the time of termination.

### **KCMBS Comments**

The KCMBS did not agree with our findings related to management incentive pay, severance pay not allocable, and outplacement costs. The KCMBS did not take exception to the other findings related to severance and incentive pay.

- ▶ **Management Incentive Pay.** The KCMBS stated that it is aware that HCFA had approved an amount different from the amount KCMBS believed was necessary to retain key staff through the transition period. The KCMBS asserted that the incentive amounts it offered and paid to Medicare management staff were reasonable; that is, the amounts were necessary to ensure staff retention through the end of the contract and comparable to what other businesses have done. The KCMBS stated that the allowability of the cost should be based on the principle of reasonableness and not restricted by the imposition of arbitrary limits.



- ▶ **Severance Pay Not Allocable.** The KCMBS stated that the principles in the FAR and the Medicare contract require that severance payments made be treated as a direct cost in the period incurred and, therefore, assignable solely to the Medicare contract. It further commented that KCMBS has adhered to generally accepted accounting principles in recognizing the total severance payments in the ‘final Medicare contract accounting period and believes that this practice meets every test for allowability.

The KCMBS referred specifically to 48 CFR 3 1.201-4 which permits allocation of costs on an equitable relationship other than on the basis of benefits received. The KCMBS stated that a causal relationship must be used as the basis for allocability because it is difficult to establish that any line of business received a benefit from severance payments caused solely by the Medicare contract termination.

The KCMBS stated that the two employees, who worked on a project for which the KCMBS Medicare contract was not to bear any costs, were hired prior to the beginning of that project and, at the time of their termination, were dedicated to the Medicare contract. The KCMBS acknowledged that these employees supported the nonchargeable project during their period of service at KCMBS. However, KCMBS asserted that their severance was caused exclusively by the Medicare contract termination and the payments should be fully allowable on that basis.

In addition, KCMBS asserted that the employees with service at another organization absorbed by KCMBS were dedicated to the Medicare contract in their previous positions.

- ▶ **Outplacement Costs.** The KCMBS only took exception with \$10,505 of the \$29,623 of questioned outplacement costs. The KCMBS indicated that it is inconsistent that HCFA would not allow costs incurred in performing actions that were undertaken at the specific direction of HCFA. The KCMBS cited a June 24, 1993 letter in which HCFA asked KCMBS to provide assistance with job placement to individuals not offered jobs by the successor contractor. The KCMBS also maintained that these costs met the tests of reasonableness provided in the FAR.

### **OIG Response**

- ▶ **Management Incentive Pay.** Although KCMBS contended that the amounts of management incentive pay were reasonable, the payments exceeded the limit established by HCFA. Further, KCMBS did not provide any evidence that the amount allowed by HCFA was not reasonable.
- ▶ **Severance Pay Not Allocable.** We agree that it is appropriate to allocate the total severance payments to the final Medicare accounting period due to the unpredictable nature of this type of cost. This is consistent with the Statement of Financial Accounting Standards No. 5, Accounting for Contingencies. However, it is not appropriate to allocate the total severance payments to Medicare.

Severance payments were based on service already received by all KCMBS's lines of business. Therefore, it was possible to establish that both Medicare and KCMBS's private lines of business received benefit from services provided by terminated Medicare employees in proportion to the employees' years of service to the various lines of business. The KCMBS was instructed by HCFA in a letter dated December 22, 1993 to allocate, prior to submitting a claim for reimbursement, severance pay based on Medicare and non-Medicare years of service.

Whether the two employees who supported the nonchargeable project were not assigned to that project on their first and/or last date of service with KCMBS is irrelevant to the fact that they did provide support to that project during their time of service to KCMBS. Consequently, their service **was** not 100 percent chargeable to KCMBS's Medicare contract and their severance pay was subject to allocation as required by HCFA.

For those terminated employees with prior service at another organization, the personnel records document that they were not 100 percent Medicare at the prior organization as suggested by KCMBS. Therefore, their severance pay was subject to allocation as required by HCFA.

- ▶ **Outplacement Costs.** Although HCFA's June 1993 letter directed KCMBS to provide job placement assistance to terminated employees not offered positions with the successor contractor, in an August 1993 letter from HCFA and when the budget was later approved in December 1993, outplacement costs were specifically identified by HCFA as being unallowable. Our review disclosed that the costs were incurred after KCMBS was notified that they were unallowable for reimbursement.

**Note 3 - Facilities Costs.** Of the \$264,613 in facilities costs claimed by KCMBS, we found that \$163,916 was acceptable for reimbursement. The remaining \$100,697 represents costs questioned for rental payments to an organization under the ownership and control of KCMBS. The amount questioned represents rent payments that exceeded the costs of ownership.

The KCMBS owned 80 percent of the joint venture to which it paid rent. The 48 CFR 31.205-36 states that charges for rent between organizations under common control are allowable to the extent that they do not exceed the normal costs of ownership. Rent was claimed at the amount of the recorded rent expense, which exceeded the costs of ownership.

### **KCMBS Comments**

The KCMBS did not take exception to this finding.

**Note 4 - Professional Fees.** We determined that \$5,000 of the \$112,184 claimed for professional fees was acceptable for reimbursement. We are questioning the remaining

\$107,184 because KCMBS did not obtain prior written approval as required by the Medicare contract.

The KCMBS retained an outside consultant for the preparation of the termination budget. In negotiations between HCFA and KCMBS, HCFA agreed that \$5,000 was reasonable for Phase I of the services to be provided. According to KCMBS, the cost of the services to be provided under Phases II and III would be determined by the consultant based on the analysis conducted as part of Phase I.

The Medicare contract, Section II Part I B., requires the prior written approval of the contracting officer for the use of services of any consultant where such reimbursement exceeds or may exceed \$400 per day or \$100,000 per year, exclusive of travel costs. The hourly billing rates for the consultants ranged from \$70 to \$290. A cost estimate for the work to be performed during Phases II and III was not submitted to HCFA for approval.

### **KCMBS Comments**

The KCMBS acknowledged that HCFA had established a limit on the amount of professional fees to be reimbursed. The KCMBS stated that it had attempted to obtain HCFA approval for obtaining the services, but that HCFA took an unreasonable position in refusing to grant approval for the entire amount proposed.

The KCMBS asserted that engaging professional assistance was necessary for two reasons: (i) lack of expertise with government contract terminations and (ii) operating and termination reporting requirements imposed by HCFA.

### **OIG Response**

As previously stated, HCFA established a limit of \$5,000 for professional fees for Phase I of the services to be provided. Although KCMBS stated that it attempted to seek approval, KCMBS did not submit revised cost proposals for Phases II and III to HCFA for approval as required by its Medicare contract.

**Note 5 - Bureau Costs.** The KCMBS claimed \$123,462 for costs, categorized as bureau costs, for separate organizations (bureaus) that assisted in processing Medicare claims. Of that amount, comprised of severance and incentive payments, we found \$109,108 to be acceptable for reimbursement and are questioning \$14,354.

Of the questioned amount, \$10,044 represents severance payments claimed by Medical Services Corporation (MSC). In negotiations with HCFA, it was disclosed that MSC had no severance pay policy. As a result, HCFA did not approve severance pay for MSC. An established severance pay policy is required by 48 CFR 3 1.205-6(g) for this cost to be allowable for reimbursement by Medicare. We are also questioning \$4,310 in severance pay and related payroll taxes for Pierce County Medical Bureau (PCMB) because PCMB miscalculated the severance payment for one employee.

**KCMBS Comments**

The KCMBS asserted that severance pay of \$10,044 for the terminated employees at MSC was clearly identified in the termination cost proposal and accepted in writing by HCFA.

The KCMBS indicated agreement with the adjustment of \$4,310 in severance pay that was miscalculated by PCMB for one employee.

**OIG Response**

Although KCMBS asserted that the severance pay for MSC was included in the approved budget, our review disclosed that the budget did not include that cost. Further, KCMBS did not dispute that MSC did not have a severance pay policy prior to notification of termination by HCFA.

# **APPENDIX**



1800 NINTH AVENUE / P O BOX 21267/SEATTLE, WASHINGTON 98111-3267/206 464-3600

September 20, 1995

Lawrence Frelot  
Regional Inspector General  
for Audit Services  
Region IX  
50 United Nations Plaza  
Room 171  
San Francisco, CA 94102

Re: CIN A-10-95-00003

Dear Mr. Frelot:

This letter represents King County Medical Blue Shield's (KCMBS) response to the draft report of your audit of termination costs claimed by us under Medicare Contract No. HCFA 90-045-2 for the period January 1, 1994 through December 31, 1994.

We commend your auditors for their diligence and professionalism throughout the conduct of the audit. There are, however, several conclusions presented in the draft report with which we must take exception. In every case, the cost was incurred as a direct result of performing some activity either requested by or required by the Health Care Financing Administration (HCFA). Although the HCFA did not always appreciate the complexities of the various obligations of a company operating in a competitive environment, we believe that all our actions were both prudent and reasonable, and always focused on achieving the goals of the Medicare program.

Unfortunately, the circumstances of the contract termination did not permit a fair negotiation of the costs to complete the contract transition and termination. Because we had less than 180 days between the final decision to terminate our contract and the actual contract end date, we did not always have the opportunity to negotiate reasonable agreements before being required to perform. Therefore, many of the findings presented in your draft report concern issues where the HCFA had unilaterally imposed arbitrary limits despite, our efforts to negotiate reasonable amounts.

In preparing our requests for reimbursement, we sought *only* to be reimbursed actual costs incurred to the benefit of the Medicare program, with appropriate inclusion of overhead costs. We attempted to adhere to the same principles and regulations which governed administrative cost accounting under the Medicare contract, even though no formal contract exists between KCMBS and the HCFA after December 31, 1993.

This response to the draft audit report will only address those areas where we take exception. For any finding not addressed in this response, it may be understood that KCMBS will not take exception.

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Having acted in good faith during and subsequent to the period of our service to the Medicare program, KCMBS respectfully requests a fair consideration of the facts presented in this response, and correction of your audit report to remove those findings that cannot be upheld in light of said facts.

Sincerely,

A handwritten signature in cursive script that reads "Edward C. Freutel".

Edward C. Freutel  
Vice President, Government Programs

Enclosure

cc: Lori Ahlstrand, OIG, Region X

Response by King County Medical Blue Shield  
to the Draft Report of the Audit of Termination Costs  
Under Medicare Contract No. HCFA 90-O-15-2  
CIN: A-10-95-00003

ED1 Costs - \$47,610. The auditors have questioned these costs on the premise that the HCFA set a limit on the amount of cost that could be charged for this activity.

During planning for the transition from KCMBS to the successor contractor, the HCFA requested that KCMBS continue to clear Medicare claims received in electronic media through our Electronic Data Interchange (EDI) networks. The purpose of this request was to assist the successor contractor in maintaining the same high percentage of electronic media claims (EMC) processing that was being provided by KCMBS.

KCMBS agreed to perform this service for one year, beginning on January 1, 1994, and ending on December 31, 1994. In consideration of performing this service, KCMBS was to be reimbursed direct costs incurred in this activity, with the inclusion of appropriate overhead costs. In this way, KCMBS would not suffer an economic damage, and the HCFA would continue to benefit from the cost efficiencies generated through EMC activities.

An estimated cost to perform this service was included in the document entitled "Proposed Termination Costs" which was prepared and submitted by KCMBS. It was made clear on numerous occasions, and noted in the proposal that all costs were estimates.

The costs claimed are the result of allocating the total costs incurred by our ED1 department in operating and maintaining the ED1 networks to all lines of business that received claims electronically. The basis for allocation was the number of claims received by each line of business. This method of assigning costs allowed the Medicare program to share equitably in the cost efficiencies realized by our private lines of business.

*Office of Audit Services Note: Comments have been deleted at this point because they pertain to material included in the draft report but not included in this final report.*



Response by King County Medical Blue Shield  
to the Draft Report of the Audit of Termination Costs  
Under Medicare Contract No. HCFA 90-045-2  
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*Office of Audit Services Note: Comments have been deleted at this point because they pertain to material included in the draft report but not included in this final report.*

**General and Administrative Expenses** - \$35,698. The auditors have questioned this cost on the basis that they are related to ED1 costs questioned above. In arguing that the ED1 costs should be reimbursed, KCMBS also submits that the associated General and Administrative costs should also be reimbursed.

**Management Incentive Pay** - \$114,234. The cited basis for questioning the cost is the fact that it exceeds an amount approved by the HCFA. The auditors' note further states that KCMBS "properly" excluded this amount through our vouchering procedure, but included it in a final voucher.

KCMBS is aware that the HCFA had approved an amount different from the amount that was necessary to create incentives for key staff to remain with us until a smooth transition could be completed. We believe, however, that the allowability of the cost should be based upon the principle of reasonableness (48 CFR 31.201-2(a)(1)), and not restricted by the imposition of arbitrary limits.

The Federal Acquisition Regulations (FAR) state "A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business." (48 CFR 31.201-3(a)). It is further stated that what is reasonable depends upon a variety of considerations, including generally accepted sound business practices (48 CFR 31.201-3(b)(2)) and the contractor's responsibilities to the Government, other customers, employees, and the public at large (45 CFR 31.201-3(b)(3)). It is our opinion that the incentive plans offered and paid to our Medicare management staff meet all of these referenced tests for reasonableness.

The Termination of Contract clause of the Medicare contract requires the Carrier to "use its best efforts to accomplish an orderly transition of its responsibilities to the successor contractor." (Article XXVII(E)) Faced with this responsibility, KCMBS deemed that our best efforts included retention of the knowledge and skills vested in our management staff, and therefore it was incumbent upon us to retain the benefit of that staffs involvement through the successful transfer of work.

The clearly stated goal of the contract transition period was to cause the smooth transfer of responsibilities from KCMBS to the successor contractor with the minimum disruption to Medicare beneficiaries and participating providers. Since contract

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transitions have been rare in the program's history, and the specific circumstances of every Medicare operation are unique, the smooth transition required careful planning, and the development of policies and procedures to control the plan execution. Since this is the province of management staff, retaining the staff was part of KCMBS's responsibility to the Medicare program.

In approving a portion of our proposed management incentive program, the HCFA confirms in essence that there is benefit to the program to retain staff through the end of the contract. This fact is also stated explicitly in a letter from Nancy Rothwell, HCFA Termination Project Officer, to Ed Freutel, KCMBS Vice President for Medicare. The letter, dated August 11, 1993, states "we agreed it benefits the transition to have employees stay with KCMBS until the end of the contract."

The question, then, is whether or not the amount of incentive offered and paid was reasonable in the contest of this business environment. KCMBS believes that the amounts were both necessary to ensure staff retention through the end of the contract, and that the amounts were comparable to what other businesses have done.

The circumstances of the contract transition included the successor contractor's announced intention to offer positions to all KCMBS Medicare employees except for management staff. This left our managers and supervisors facing the certainty of unemployment at the contract termination date and, with the general restructuring in all health care related industries, many anticipated protracted periods of unemployment. These circumstances created an incentive for each of them to seek alternative employment at the earliest possible time, even if that were prior to the contract termination data. To counter these understandable human motives, KCMBS recognized the need to offer reasonable incentives to the management staff.

An incentive is only effective if it is sufficient to insure the desired outcome, and is established before the time of desired performance. Without direct experience in these matters, KCMBS engaged the services of Drake Beam Morin, Inc., an internationally recognized firm of outplacement consultants, to advise us in determining a fair and reasonable incentive package. This firm also participated with us in discussions with Region X staff during which we presented our belief in the necessity for the incentive as well as our basis for concluding that the eventual offering was consistent with established business practices for firms of our type and size.

KCMBS understands the HCFA's need to limit the costs associated with the contract transition, but we cannot accept cost control as the only reasonable basis for determining the amount necessary to achieve the desired outcome. The HCFA never offered evidence of any objective basis for establishing the amount of incentive they

Response by King County Medical Blue Shield  
to the Draft Report of the Audit of Termination Costs  
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proposed. Had they done so, perhaps a fair negotiation could have arrived at a different solution. Absent any agreement in advance of the fact, however, KCMBS had no choice but to act in reliance on our own sound business judgment, and on the advice of our expert consultants, with the expectation that the FAR cost principles support full reimbursement of this reasonable cost.

The reasonableness of the strategy, and the ensuing benefit to the Medicare program, is best proved by the success of the outcome. In a January 11, 1994 letter to Mr. Bruce Vladeck, Charles Gustafson, Aetna Vice President of Medicare Administration, said "the system conversion from King County Medical Blue Shield to Aetna has been flawless." Mr. Gustafson further states that "Current backlog is approximately 25% of what we had originally planned for."

KCMBS is proud of our performance during this difficult period, and are pleased that Mr. Gustafson's comments indicate that this transition avoided the serious problems that had, according to the GAO, been apparent in other contract transitions.

We would also respond to the auditors' comment that these questioned costs were excluded from claims submitted early in the termination period, but included in a final voucher. This action was undertaken at the direction of HCFA staff who told us that no progress payments would be made if we claimed any costs over any limits that had arbitrarily been imposed by the HCFA. Therefore, with each claim submission, we clearly noted that the costs were being claimed in an amount no greater than what had been "approved", but that we always reserved the right to claim full cost incurred at a later date.

Severance Pay Not Allocable - \$31,343. The auditors cite 48 CFR 31.201-4(b) as the basis for questioning a portion of severance pay which KCMBS has treated as a direct cost to the Medicare contract. Essentially, the auditors interpret this paragraph to imply the need to prorate the severance payments where the length of service basis included work in non-Medicare lines of business. The premise is that a cost is allocable to a government contract if it benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received.

KCMBS takes exception to this finding on the basis that the cited clause has been misinterpreted, and that the auditors' suggestion is not workable in the context of the Medicare contract. We believe that correct practice of the principles included in the FAR and the Medicare contract require that the severance pay be treated as a *direct* cost in the period incurred, and therefore assignable solely to the Medicare contract.

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The crucial language of 48 CFR 31.201-4 reads “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.” The question at issue is whether the cost is truly assignable to more than one cost objective, and whether that assignment is based on relative benefits received or on some other equitable relationship.

The Medicare contract itself creates difficulty with respect to assigning the severance pay to more than one cost objective. It is a well established cost principle in the Medicare environment that each fiscal year is a distinct accounting period. Budget appropriations become available *on* the first day of the fiscal *year*, and funds cannot be carried over from year to year unless certain requirements are met to obligate current year budget funds in a future year. Furthermore, the FAR specifically disallows any cost based on an accrual for the contingency of mass severance. (48 CFR 31.205-6(g)(2)(iii)).

It is KCMBS's established accounting practice to allocate all personal service costs on the basis of the direct labor cost incurred during the accounting period in which the cost is recognized. Absent any allowability prior to the contract termination becoming a certainty, and given the existence of an established accounting practice, we believe that expensing and allocating 100 percent of the cost based on current period activities is an appropriate accounting practice.

It is also relevant that KCMBS's accounting period is the calendar month. Although this is different from other government contract cost principles (CAS 406), it is an implicit fact of the Medicare contract, which requires monthly reporting of actual costs.

The auditors' position implies an expectation that this cost can be moved in and out of accounting periods almost at will. KCMBS believes that generally accepted accounting principles (GAAP) discourages such a practice. This *is* the reason accountants employ accruals for recognizing expenses in the period incurred. Since the FAR correctly recognizes that a mass severance is so unpredictable in nature as to make an accrual too speculative to be reasonable (48 CFR 31.205-6(g)(2)(iii)), KCMBS has followed the approach of fully recognizing the liability in the period during which it became a certainty. The FAR rules for determining allowability state that the factors to be considered in determining allowability, absent the applicability of the Cost Accounting Standards, include “generally accepted accounting principles and practices appropriate to the particular circumstances.” (48 CFR 31.201-2(a)(3)). KCMBS has adhered to GAAP in recognizing the total severance in the final Medicare contract accounting period, and believe this practice meets every test for allowability.

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We further believe that the fallacy of the auditors' position is apparent if the implied principle is applied to other circumstances over time. Consider the case of an employee who worked on a company's cost reimbursement government contract for five years, until the contract was terminated. At the contract end date, the employee was transferred to the company's private business operations. Five years later, however, the employee was laid off with a severance package based on the most recent ten years of service. Do the auditors intend to imply that the government would accept a liability for half of the employee's severance based on service performed five years prior?

If the proposed solution were in fact an established cost principle, it would imply that every government contract would have a liability for severance payments made to any individual who had ever worked on a government cost reimbursement contract. We cannot believe that it is the government's intention to honor any future claim we may submit in the eventuality of severance payments we may make to any employee who had worked on our Medicare contract prior to transferring to our private business operations. Nor do we believe that the government intends to establish a cost principle that creates a similar possibility relative to all past and present cost reimbursement contracts.

In citing 48 CFR 31.201-4(b), the auditors have restricted their reference to language that discusses cost allocation on a basis representative of the benefits received. The main clause of 48 CFR 31.201-4, however, is much broader, permitting allocation not only on the basis of benefits received, but also on some other equitable relationship. In the case of severance pay, KCMBS believes that it is very difficult to establish that any line of business receives a benefit, and we look to a causal relationship as the basis for allocability. Without question, the mass severance we experienced was caused solely by the Medicare contract termination, and therefore the resulting cost was incurred specifically for that contract and is allowable in full under 48 CFR 31.201-4(a).

The draft report also makes specific mention of two employees who were assigned at some time during their service to support our shared system arrangement with Blue Cross and Blue Shield of Montana. It should be noted that each of these employees supported this otherwise non-chargeable contract at separate times, so that neither can be thought of as being wholly dedicated to this project. It is also relevant that both employees' service predates the shared system arrangement, so once again cannot be connected exclusively with the shared system contract. The more relevant issue, however, is that both persons were dedicated to the Washington state contract at the time of their layoff. Their severance is inextricably tied to the Washington contract termination, and should be allowed on the same basis as discussed above.

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The report further references the fact that some of the employees laid off by KCMBS had been given service credits dating back to their time with another organization that was absorbed into KCMBS. The facts are that these people were dedicated to the Medicare contract in those previous positions, that they were hired by KCMBS to further the transition of the Medicare contract from the prior contractor to KCMBS, and that continuation of length of service credits was a condition of those employees' hiring by KCMBS. Furthermore, the previous employer was a Blue Shield plan which participated with KCMBS in a long established practice of offering continuity of services credits to employees who transferred between organizations.

We also ask you to consider that KCMBS's claim for full recovery of severance costs is based on an amount that was actually paid to severed employees. There is no portion of the claimed cost that would be recognized as revenue by the company. Because the Medicare contract is based on the principle of cost reimbursement, KCMBS never had an opportunity to recognize profit that could be used to offset contingencies such as a mass severance cost that is less than fully chargeable.

Outplacement Costs - \$29,623. There are two components of cost in this category. First are charges for change management seminars which were intended to help the employee population to adjust to the human impacts of major career transitions. Second were charges for outplacement services which consisted of career counseling and job search assistance provided to terminated Medicare contract employees. These costs are questioned on the basis that they had been specifically excluded from the incentive pay package approved by HCFA.

KCMBS finds it ironic that the HCFA would disallow costs incurred in performing actions that were undertaken at the specific direction of the HCFA. In a June 24, 1993, letter to Ed Freutel, KCMBS Vice President for Medicare, Nancy Rothwell, HCFA Termination Project Officer, gave several instructions under the heading of "Minimize Staffing Losses". These include establishing motivational techniques, develop an employee counseling program, and provide job placement assistance to those employees not offered jobs with Aetna.

At this time, however, KCMBS is only taking exception with a finding in the amount of \$10,505 paid to Drake Beam Morin, Inc. for outplacement services. As a large employer, we recognize a responsibility to our employees to do everything within our power to provide for their security. This is a matter we take seriously, even to the point of assisting employees who are being separated from the company. Since KCMBS was not able to make positions available within the company for all employees who were being severed as a result of the Medicare contract termination, it was reasonable to

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make available and pay for the services of recognized experts in the field of outplacement counseling.

It is this responsibility to our employees that should be the basis for determining the allowability of the resulting costs. The test for reasonableness at 48 CFR 31.201-3(b)(3) suggests that a cost is reasonable when it is incurred as the result of the contractor's responsibility to its employees. Furthermore, 48 CFR 31.201-3(b)(2) states that a cost is considered reasonable when it is the result of generally accepted sound business practices. Providing outplacement counseling to displaced employees is certainly a common business practice, and firms such as Drake Beam Morin, Inc. have built substantial businesses on that practice.

Finally, the cost must be considered as 100 percent allocable to the Medicare contract because of the causal relationship that exists between the termination of that contract and the necessity of incurring the cost. (48 CFR 31.201-4).

Professional Fees - \$107,184. The auditors have questioned this amount on the basis that the cost exceeds a limit of \$5,000 that was established by the HCFA. The HCFA never presented any factual evidence that would support the reasonableness of this limit, and no agreement exists between the HCFA and KCMBS on this point.

The auditors are not incorrect in citing the Medicare contract, Section IL Part I B., which sets thresholds for the amount of consultant fees that can be claimed without the prior written approval of the contracting officer. We would argue, however, that this citation does not address KCMBS's efforts to seek such approval, nor the HCFA's unreasonable position in refusing to grant approval.

On several occasions, HCFA staff stated that they would not approve fees for consultants hired for the purpose of "stacking" the amount of our claim. This attitude is not only inappropriate, but it ignores the impossibility of such an outcome. Since our transition and termination costs were limited to the maximum of costs incurred, and subject to audit by the Office of the Inspector General, there has never been a possibility that cost reimbursements would exceed the amount to which KCMBS is entitled. The HCFA's unwillingness to negotiate in good faith on this point should mitigate the contract's requirement of advance approval.

The full amount of these costs should be allowable based on the reasonableness and allocability requirements of 48 CFR 31.201-2. We also believe that our circumstances meet the conditions described at 48 CFR 31.205-33.

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KCMBS determined that it was necessary to engage expertise from external sources for two reasons. The primary concern was our own staffs lack of experience with government contract terminations. Neither the Medicare contract nor the Medicare Carriers Manual contain guidance or procedures for contract terminations. We did request guidance and instruction from Region X, but found that HCFA staff were no better prepared than KCMBS staff. Also, the information that the HCFA did eventually provide proved to be sparse, mostly not applicable, and often incorrect.

Our secondary concern was over the additional workload required by the circumstances of the contract termination. Because we were still in a normal contract operation, existing staff continued to have usual reporting responsibilities. These were compounded by a three month extension in the contract, which required a normal budget request, as well as preparation of a Final Administrative Cost Proposal for one quarter of a fiscal year. The HCFA also imposed additional monthly reporting requirements to facilitate their close scrutiny of the contract's financial status during the closing months. We were also required to submit a special proposal detailing our estimated termination costs.

To meet these requirements, KCMBS determined that we needed to *engage* additional assistance. We believed that qualified professionals would have expertise in government contracting requirements as well as accounting. Therefore, we requested proposals from the consulting branches of four of the "big six" accounting firms. We asked that the respondents identify the relevant experience of the staff being proposed and quote an hourly rate for each participant. The request for proposals could not be made specific as to the scope of work because determining that scope was part of the intended engagement.

We believe that the consultants benefited the Medicare program by bringing expert knowledge into a situation where neither the contractor nor the cognizant government agency had any experience. Rather than strengthening KCMBS's position with respect to termination costs, the consultants caused necessary work to be completed in a timely and equitable manner.

**Bureau Costs - \$10,044 (Medical Service Corporation).** The auditors questioned severance pay costs claimed by Medical Service Corporation (MSC) on the basis that no established severance policy was in place prior to the announcement of the contract termination.

Although MSC's severance pay policy was established specifically for this contract termination, the costs are allowable based on an advance agreement between the HCFA and MSC. These severance costs were clearly identified in the termination cost



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proposal submitted by **KCMBS** to the HCFA. In a letter to Ed Freutel, **KCMBS** Vice President for Medicare, dated December 22, 1993, Nancy Rothwell, HCFA Termination Project Officer, enclosed a document entitled "Review of Proposed Termination Costs Under the Medicare Program". Note 6 of this document identifies an amount of \$203,137 as being reasonable and acceptable. That amount includes the MSC severance pay.

The agreement was made prior to the cost being incurred, covered by the HCFA letterhead, and signed by an authorized HCFA representative. Section I, Article I of the Medicare contract states at Paragraph J that "any written statement with respect to matters covered by this contract by . . . the HCFA Regional Administrator and such other positions as the Regional Administrator authorizes . . . shall have the same force and effect as though issued by the Secretary." Nancy **Rothwell** has been identified to us as the appropriately designated authority.

Bureau Costs - **\$4,310** (Pierce County Medical Bureau). Pierce County Medical will not take exception with this finding.