DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date AUG 1 6 1999

From June Gibbs Brown June G Brown
Inspector General

Subject Results of Review of Administrative Costs Included in the Adjusted Community Rate Proposal for a Florida Medicare Managed Care Risk Plan (A-04-98-01188)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

The attached final report is one in a series of reports that is part of our overall review of the administrative costs planned and incurred by managed care organizations (MCO) relative to their operating a Medicare risk managed care plan. Because MCOs view the use of administrative funds to be a sensitive matter and the Medicare managed care program is essentially a concentrated Health Care Financing Administration (HCFA) central office operation, we want to share these individual MCO reports directly with you.

On July 27, 1998 we issued a report entitled, "Administrative Costs Submitted by Risk-Based Health Maintenance Organizations on the Adjusted Community Rate Proposals Are Highly Inflated" (A-14-97-00202). This report examined the allocation of administrative costs on the Adjusted Community Rate (ACR) proposals for contract years 1994 through 1996. We concluded that the methodology which allowed MCOs to apportion administrative costs to Medicare was flawed and that Medicare covered a disproportionate amount of the MCO's administrative costs. The attached report on selected administrative costs of a Medicare managed care risk plan located in Florida (the Plan) provides some insight on where some of the excess administrative costs may be used.

The 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 services to any enrolled Medicare beneficiary. The ACR proposal is integral to pricing an MCO benefit package, computing savings (if any) from Medicare payment amounts, and determining additional benefits that will be provided beneficiaries or reduced premiums that could be charged to the Medicare enrollees. Included as MCO's administrative costs are the non-medical costs of compensation, interest, occupancy, depreciation, marketing, reinsurance, claims processing, and other costs incurred for the general management and administration of the business unit.

The objective of this review was to examine the Plan's administrative cost component of the 1997 ACR proposal, and assess whether the costs were appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs.

Our review found that $2.5 million charged to administrative costs was not appropriate when compared to the Medicare program's general principle of paying only reasonable costs. These costs may have been eliminated when computing the ACR if Federal Acquisition Regulations Contract Costs Principles were applied to risk-based MCOs. The majority of the $2.5 million in questionable costs was attributed to charges for brokers' commissions ($2.1 million). These costs were payments to brokers who sold the Plans' commercial policies to outside individuals and companies. Based on the Plan's allocation formulas, the entire $2.1 million was allocated to the Medicare program. The remaining questionable costs related to travel and entertainment, public relations, office expense, repairs and maintenance, seminars, and auto allowance.

We were unable to complete our review of travel and entertainment, and repairs and maintenance because Plan officials did not provide documentation to support expenses in the amount of $50,456. Due to the Plan's impairment to the scope of our review, we are unable to conclude on the reasonableness of all administrative costs we selected for review.

These costs would not be allowable if they were submitted by MCOs under cost contracts or if submitted by health care providers paid under a Medicare cost reimbursement system. We believe these administrative costs should not be included in the ACR proposal since this only serves to increase the ACR. An unjustifiably increased ACR adversely impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Presently, there is no statutory or regulatory authority governing allowability of costs in the ACR process for risk MCO contracts 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.

Because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations addressed to the Florida plan. In response to our draft report, the Florida MCO stated that it complied with all rules and regulations that were in effect at the time the ACR proposal was submitted to HCFA. It added that there were no regulations regarding the admissibility of administrative expenses.

While this review examined only one plan, we believe that our results of this plan, and others previously issued, highlight a significant problem. Additional reviews are underway and preliminary results show there are similar findings 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 comments on our review as it proceeds.

If you have any questions, please contact 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-04-98-01188 in all correspondence relating to this report.

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

RESULTS OF REVIEW OF ADMINISTRATIVE COSTS INCLUDED IN THE ADJUSTED COMMUNITY RATE PROPOSAL FOR A FLORIDA MEDICARE MANAGED CARE RISK PLAN

JUNE GIBBS BROWN
Inspector General

AUGUST 1999
A-04-98-01188

Memorandum

Date AUG 16 1999

From June Gibbs Brown
Inspector General

Subject Results of Review of Administrative Costs Included in the Adjusted Community Rate Proposal for a Florida Medicare Managed Care Risk Plan (A-04-98-01188)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

This final report presents the results of our review of the administrative costs included in the adjusted community rate (ACR) proposal submitted to the Health Care Financing Administration (HCFA) for the 1997 Medicare contract year by a Florida managed care risk contractor (the Plan). The objective of our review was to examine the Plan's administrative cost component of the ACR proposal, and assess whether the costs were appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs.

The Medicare ACR process is designed for managed care organizations (MCO) to present to HCFA their estimate of the funds needed to cover the costs of providing the Medicare package of covered services to any enrolled Medicare beneficiary. The MCO's anticipated or budgeted funds are calculated to cover the medical and administrative costs of the Plan for the upcoming year and must be supported by the individual MCO's operating experiences relating to utilization and expenses. All assumptions, cost data, revenue requirements, and other elements used by MCOs in the ACR proposal calculations must be consistent with the calculations used for the premiums charged to non-Medicare enrollees. The ACR proposal is integral to pricing an MCO's benefit package, computing savings (if any) from Medicare payment amount, and determining additional benefits or reduced premiums that could be charged to Medicare beneficiaries.

Presently, 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 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.

Based on the audit work completed, $2,508,901 in costs may have been eliminated when computing the ACR if Federal Acquisition Regulations Contract Cost Principles were applied to risk-based MCOs. The $2,508,901consists of charges for brokers' commission, travel and entertainment, public relations, office expense, repairs and maintenance, seminars, and auto allowance.

In addition, we did not complete the review of travel and entertainment, and repairs and maintenance because plan officials did not provide documentation to support expenses in the amount of $50,456.

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 savings from the Medicare payment amounts. In addition, this methodology impacts the amounts available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Because of 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.

INTRODUCTION

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. The development of a base rate is the first step of the process. The base rate is the amount that the MCO will charge its non-Medicare enrollees during the contract period. The next step in the process is to develop adjustments to arrive at the initial rate which is the rate the Plan would have charged its commercial members if the commercial package was limited to Medicare coverage. The adjustments eliminate the value of those services not covered by Medicare that were included in the base rate or, add the value of covered Medicare services not included in the base rate.

After the calculation of the initial rate, the rate is multiplied by utilization factors to reflect differences between Medicare members and non-Medicare members with regard to volume, intensity, and complexity of services. This last calculation results in the ACR. If the average Medicare payment rate is greater than the ACR, a savings is noted. The MCO is required to use the savings to either improve their benefit package to the Medicare enrollees, reduce the Medicare enrollee's premium, accept a reduced capitation payment, or contribute to a benefit stabilization fund. 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 proposal calculations must be consistent with the calculations used for the premiums charged to non-Medicare enrollees.

The MCO cost data will be especially important due to the changes in the ACR proposal brought about by the Balanced Budget Act of 1997 (Public Law 105-33) which authorizes the Medicare+Choice program. Under HCFA's new format for the ACR proposals, beginning with contract year 2000, administrative costs will be determined using a relative cost ratio based on actual administrative costs incurred for Medicare beneficiaries in a base year (prior 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.

SCOPE

The objective of our review was to examine the Plan's administrative cost component of the ACR proposal, and assess whether the costs were appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs. To accomplish our objective, we:

- discussed the ACR proposal and how the administrative costs were derived with the Plan's Regional Director of Regulatory Affairs and the Plan's Director of Finance; and

- selected from the Plan's general ledger certain categories of administrative costs which traditionally have been shown to be problematic areas in the Medicare fee-for-service program.

The 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 administrative costs submitted by the Plan. Field work was done at the Plan's office during the months of July 1998 through January 1999.

We reviewed the Plan's 1996 financial records which were used to support the 1997 ACR proposal. We selected transactions totaling $11,412,725 from the general and administrative costs of approximately $33 million. These transactions included non-medical costs associated with non-medical compensation, occupancy and amortization, marketing, and other administrative costs. Most of our selections were from the following general ledger accounts: travel and entertainment, office expense, auto allowance, seminars, public relations, repairs and maintenance, and brokers' commissions. We requested the corresponding supporting documentation for the items selected, including check registers, paid invoices, and journal entries.

The audit was performed in accordance with generally accepted government auditing standards.

FINDINGS AND RECOMMENDATIONS

We reviewed each transaction using the guidelines HCFA applies to cost-based MCOs and Medicare fee-for-service carriers, intermediaries, and providers, and found that $2,508,901 charged to administrative costs was not appropriate when compared to the Medicare program's general principle of paying only reasonable costs.

These costs included:

Administrative Costs Not Traditionally Allowed by Other Medicare Programs

- **Brokers' Commissions - $2,106,246** of the $10,640,627 reviewed was related to commercial policies and not to the Medicare program. These costs were payments to brokers who sold the Plan's commercial policies to outside individuals and companies. Based on the Plan's allocation formula, the entire $2,106,246 was allocated to the Medicare program.

- **Travel and Entertainment - $186,908** of the $223,872 reviewed was not related to patient care. This category included costs for employees' social functions, holiday parties, catered meals, and contributions to health associations and social organizations. Based on the Plan's allocation formula, at least $56,072 was allocated to the Medicare program.

- **Public Relations - $129,769** of the $304,191 reviewed was for sponsorships of sports activities, carnivals, chamber membership meetings, chamber membership dues, gambling, golf tournaments, holiday gift baskets, holiday cards, crystal awards, and promotional items. Based on the Plan's allocation formula, at least $38,931 was allocated to the Medicare program.

- **Office Expense - $24,981** of the $71,372 reviewed was to purchase office furniture, appliances, and coffee service for the office. The furniture and appliances should have been depreciated according to company policy and not expensed in this category. The coffee service was not reasonable and necessary and not related to patient care. Based on the Plan's allocation formula, at least $7,494 was allocated to the Medicare program.

- **Repairs and Maintenance - $57,549** of the $136,901 reviewed had either no supporting documentation or was for plants and plant containers for various departments with no indication that the expenses were related to patient care. Based on the Plan's allocation formula, at least $17,265 was allocated to the Medicare program.

- **Seminars - $2,760** of the $31,003 reviewed was for payments to a local chamber of commerce, charitable contributions to a local health council and health association, and catered meals. Based on the Plan's allocation formula, at least $828 was allocated to the Medicare program.

- **Auto Allowance - $688** of the $4,759 reviewed was for mileage reimbursed to one individual to attend a holiday party not related to patient care. Based on the Plan's allocation formula, at least $206 was allocated to the Medicare program.

The effect of including these costs in the proposal was to increase the amounts needed for administration, thus reducing any potential savings from the Medicare payment amounts. In addition, this impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

CONCLUSION

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 administrative costs should be included in the Plan's ACR proposal, since it only serves to increase the ACR. This affects the computation of potential savings from the Medicare payment amounts, and ultimately adversely impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts. We recognize that currently there is no statutory or regulatory authority governing allowability of administrative 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 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.

RECOMMENDATIONS

Notwithstanding the lack of specific guidelines for MCO risk 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 monthly MCO 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.

PLAN'S RESPONSE

The Plan stated that it complied with all rules and regulations that were in effect at the time the ACR proposal was submitted to HCFA. It added that there were no regulations regarding the admissibility of administrative expenses.

OIG COMMENTS

We recognize that risk based MCOs are not bound by Medicare's standard of reasonableness and our report does not make recommendations for financial adjustments.

We agree with the Plan's comments that there were no regulations regarding the admissibility of administrative expenses. However, certain administrative costs were not appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs. Notwithstanding the lack of specific guidelines for MCO risk contracts, we believe that those costs that would not be allowable under other areas of the Medicare program should be eliminated from the ACR calculation.