

**Memorandum**

Date AUG 5 1994
From June Gibbs Brown
Inspector General

Subject Review of Executive Compensation at Medicare Contractors (A-03-94-00004)

To Bruce C. Vladeck
Administrator
Health Care Financing Administration

Attached are two copies of our final report entitled, "Review of Executive Compensation at Medicare Contractors." This final report provides you with the results of our audit of executive compensation at Medicare contractors. Based on the results of reviews at three Medicare contractors, we determined that over \$1.2 million in unreasonable executive compensation was allocated to the Medicare program during Calendar Years (CY) 1989 to 1992.

The reasonableness of executive compensation packages of Medicare contractors' was raised in hearings held in September 1992 and June 1993 before the U.S. Senate's Permanent Subcommittee on Investigations of the Committee on Governmental Affairs. The Subcommittee hearings examined the management and operations of the Blue Cross and Blue Shield insurance network, and studied the reasonableness of compensation packages paid to top executives of the insurance companies. Two of the insurance companies under review were Blue Cross and Blue Shield of Maryland (BCBSM) and Empire Blue Cross and Blue Shield of New York (Empire). The Subcommittee concluded that the compensation packages of top executives at BCBSM and Empire were inconsistent with their charter as nonprofit organizations.

At the request of the Subcommittee, the Office of Inspector General (OIG) undertook a further review to determine if, in fact, the increases to the compensation packages of top executives at the three Medicare contractors (BCBSM, Empire, and Pennsylvania Blue Shield (PBS)) were unreasonable, and if so, the effect of these increases on the Medicare program.

We found that the top executives at the three Medicare contractors received increases to their compensation packages that were clearly in excess of the U.S. Department of Labor's Bureau of Labor Statistics Employment Cost Index (ECI).

The ECI is a quarterly measure of the hourly compensation rate and is similar in concept to the Consumer Price Index.

During the period of our review, CYs 1989 to 1992, the ECI increased 14.6 percent. In contrast, the average compensation of the 12 top BCBSM executives rose \$156,564 from \$145,430 to \$301,994 during the period of our review, an increase of 107.7 percent. At PBS the average compensation of the eight top paid executives rose \$79,252, from \$139,979 to \$219,231, an increase of 56.6 percent.

With regard to Empire, on July 6, 1993, the OIG issued an early alert memorandum (A-02-93-01030) to the Health Care Financing Administration (HCFA) in which we reported that Empire's top four executives received salary increases of 89 percent during a 6-year period (CYs 1987 through 1992) while the ECI increased only 22.6 percent during the same period. A subsequent review showed that the compensation packages of 60 Empire executives rose by over 35 percent during the period of review.

The increases in executive compensation at the three Medicare contractors during the years of our review totaled \$3,742,451 in excess of the ECI. Using the same allocation methodologies as used by the three contractors, we determined that \$1,236,103 of this excess compensation was allocated to Medicare.

We do not believe that Medicare should be allocated increases to compensation that are excessive or unreasonable. These increases seem particularly inappropriate at a time when the Medicare trust funds are facing financial uncertainty. The HCFA, in its August 9, 1993 response to our early alert memorandum on Empire, agreed with our challenging the reasonableness of the executive compensation charged to Medicare. The HCFA stated that the onus is on the Medicare contractors to show that the compensation paid to its executives is reasonable.

In view of our audit results to date and HCFA's interest, we are expanding our review of the reasonableness of executive compensation to other Medicare contractors. We are also developing an audit guide for use by nonfederal auditors who often audit the contractors' Final Administrative Cost Proposal.

We recommend that HCFA consider establishing a ceiling on executive compensation increases that Medicare contractors can allocate to the Medicare program. One method of implementing such a ceiling is to limit executive compensation increases to the increase in the ECI.

Page 3 - Bruce C. Vladeck

In responding to our draft report, HCFA concurred with our conclusions and recommendation to establish a ceiling on executive compensation increases. In establishing a ceiling, HCFA also stated that extensive contract negotiations will need to take place since the Medicare contracts are cost reimbursed agreements. In this regard, the OIG will share with HCFA supporting documentation for this report. The HCFA's comments are presented as an Appendix to this report.

We would appreciate your views and the status of any further action taken or contemplated on our recommendations within the next 60 days. If you have questions, please call me or have your staff contact George M. Reeb, Assistant Inspector General for Health Care Financing Audits, at (410) 966-7104. Copies of this report are being sent to other interested Department officials.

To facilitate identification, please refer to Common Identification Number A-03-94-00004 in all correspondence relating to this report.

Attachments

Department of Health and Human Services

OFFICE OF
INSPECTOR GENERAL

REVIEW OF EXECUTIVE COMPENSATION
AT MEDICARE CONTRACTORS



JUNE GIBBS BROWN
Inspector General

AUGUST 1994
A-03-94-00004

EXECUTIVE SUMMARY

This final Office of Inspector General (OIG) audit report presents the results of our review of the reasonableness of increases to compensation packages awarded to top executives of Blue Cross and Blue Shield of Maryland (BCBSM), Empire Blue Cross and Blue Shield of New York (Empire), and Pennsylvania Blue Shield (PBS), during Calendar Years (CY) 1989 through 1992.

The reasonableness of executive compensation packages of Medicare contractors' was raised in hearings held in September 1992 and June 1993 before the U.S. Senate's Permanent Subcommittee on Investigations of the Committee on Governmental Affairs. The Subcommittee hearings examined the management and operations of the Blue Cross and Blue Shield insurance network, and studied the reasonableness of compensation packages paid to top executives of the insurance companies. Two of the insurance companies under review were BCBSM and Empire. The Subcommittee concluded that the compensation packages of top executives at BCBSM and Empire were inconsistent with their charter as nonprofit organizations.

The OIG undertook its review to determine if, in fact, the increases to the compensation packages of top executives at the three Medicare contractors were unreasonable, and, if so, the effect of these increases on the Medicare program.

Top executives of the three Medicare contractors received increases that exceeded the Employment Cost Index by over \$3.7 million during the period of our review.

We determined that there was no universal standard for reasonableness of executive increases used by either the contractors or the Health Care Financing Administration (HCFA). We, therefore, used as a measurement of reasonableness the nationwide averages for executive and managerial employees employed in the private sector, as measured by the U.S. Department of Labor's (DOL) Bureau of Labor Statistics Employment Cost Index (ECI). The ECI is a quarterly measure of the hourly compensation rate and is similar in concept to the Consumer Price Index.

We found that the top executives at the three Medicare contractors received increases to their compensation packages that were clearly in excess of the ECI. As shown below, the increases were most excessive at BCBSM, but all three contractors exceeded the ECI for each year of the review.

AVERAGE COMPENSATION INCREASE				
<u>Year</u>	<u>ECI</u>	<u>BCBSM</u>	<u>PBS</u>	<u>Empire</u>
1989	3.5%	30.9%	17.4%	11.6%
1990	5.3%	52.1%	15.7%	8.6%
1991	4.2%	27.4%	9.3%	12.8%
1992	1.6%	7.8%	7.7%	4.7%

The percentages shown above, however, need to be expressed in terms of dollars to appreciate the full effect of the increases to the executives' compensation package. At BCBSM, the average compensation of the 12 top BCBSM executives rose \$156,564 from \$145,430 to \$301,994 during the period of our review, an increase of 107.7 percent. At PBS the average compensation of the eight top paid executives rose \$79,252, from \$139,979 to \$219,231, an increase of 56.6 percent.

With regard to Empire, on July 6, 1993, the OIG issued an early alert memorandum (A-02-93-01030) to HCFA in which we reported that Empire's top four executives received salary increases of 89 percent during a 6-year period (CYs 1987 through 1992) while the ECI increased only 22.6 percent during the same period. A subsequent review showed that the compensation packages of 60 Empire executives rose by over 35 percent during the period of review.

The increases in executive compensation at the three Medicare contractors during the years of our review totaled \$3,742,451 in excess of the ECI. Using the same allocation methodologies as used by the three contractors, we determined that \$1,236,103 of this excess compensation was allocated to the Medicare program.

We do not believe that the Medicare program should be allocated increases to compensation that are excessive or unreasonable. These increases seem particularly inappropriate at a time when the Medicare trust funds are facing financial uncertainty. The HCFA, in its August 9, 1993 response to our early alert memorandum on Empire, agreed with our challenging the reasonableness of the executive compensation charged to Medicare. The HCFA stated that the onus is on the Medicare contractors to show that the compensation paid to its executives is reasonable.

In view of our audit results to date and HCFA's interest, we are expanding our review of the reasonableness of executive compensation to other Medicare contractors. We are also developing an audit guide for use by non-Federal auditors who often audit the contractors' Final Administrative Cost Proposal (FACP). However, we are recommending that HCFA consider establishing a ceiling on executive compensation increases that Medicare contractors can allocate to the Medicare program. One method of implementing such a ceiling is to limit executive compensation increases to the increase in the ECI.

In responding to our draft report, HCFA concurred with our conclusions and recommendation to establish a ceiling on executive compensation increases. In establishing a ceiling, HCFA also stated that extensive contract negotiations will need to take place since the Medicare contracts are cost reimbursed agreements. In this regard, the OIG will share with HCFA supporting documentation for this report. The HCFA's comments are presented as an Appendix to this report.

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INTRODUCTION

BACKGROUND

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

The Act enabled the Federal Government to contract with public or private organizations to facilitate payments to providers of services and beneficiaries. These organizations are known as intermediaries under Part A and carriers under Part B. The Medicare program is administered by HCFA.

Under an agreement with the Secretary of the Department of Health and Human Services, the Blue Cross Association (BCA) participates in the administration of the Medicare Part A program. Under a subcontract with BCA, Empire and BCBSM are responsible for the receipt, review, audit, and payment of Medicare Part A claims submitted by providers they service in the States of New York, Maryland, and the District of Columbia.

For Medicare Part B, contracts are executed between HCFA and the contractors to process claims for designated geographical areas. The PBS is the contractor responsible for the administration of Part B programs in Pennsylvania, Delaware, New Jersey and the District of Columbia. The BCBSM and Empire are responsible for Part B programs in the States of Maryland and selected counties in New York, respectively.

Contractors are reimbursed for their costs under the terms of the contracts with HCFA under the principle of neither profit or loss. They are entitled to reimbursement of all allowable administrative costs claimed on the FACP, provided that the required provisions of the Medicare contract and applicable Federal regulations have been met.

Included in the administrative costs claimed for reimbursement are costs for general and administrative expenses attributable to the general management, supervision, and conduct of a contractor's business as a whole. The compensation packages of a contractor's senior executives account for a substantial portion of a contractor's general and administrative expenses that are allocated to the Medicare program for reimbursement.

SCOPE OF AUDIT

Our audit was conducted in accordance with generally accepted government auditing standards. The primary objectives of our review were to determine whether increases to the compensation packages of the highest paid executives of BCBSM, Empire, and PBS were reasonable, and if not, the affect of unreasonable increases on the Medicare program. Our review was limited to compensation increases received during CYs 1989 through 1992 to high paid executives of the three Medicare contractors.

From information obtained from the three Medicare contractors and the U.S. Senate's Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, we determined the compensation package of top paid executives for each of the 4 years under review. Not all of the executives were employed by the Medicare contractors for the entire 4-year period of our review. Therefore, in computing increases in compensation we used as the base year either the executives' actual compensation package for CY 1988, or their compensation package for a later year if not employed in CY 1988. We used as the final year of our review either the compensation package for CY 1992, or the package for the year in which the executive was terminated, if prior to CY 1992. We did not attempt to determine the reasonableness of the base year compensation packages.

In reviewing the reasonableness of increases to executive compensation, we determined that neither the three contractors, nor HCFA, had a standardized means of measurement. We, therefore, used the ECI which is developed and published by the U.S. DOL, Bureau of Labor Statistics. The ECI measures the rate of change in compensation and includes wages, salaries, and employers cost of employee benefits. The ECI uses a fixed market basket of labor--similar in concept to the Consumer Price Index's fixed market of goods and services--to measure change over time in employer costs of employing labor.

The ECI is designed as a fixed-weight index at the occupational level which eliminates the effects of employment shifts among occupations. The index weights are derived from occupational employment for ECI industries reported in the 1980 Census of Population. Several elements distinguish the ECI from other surveys of employee compensation. It is comprehensive in that it: (1) includes costs incurred by employers for employee benefits in addition to salaries and wages and (2) covers all establishments and occupations in both the private and public sector. The ECI is computed from data on compensation by occupation collected from a sample of establishments and occupations weighted to represent the universe of establishments and occupations in the economy.

The ECI is published each quarter for each industry and occupational group. In computing the ECI for executives at Medicare contractors, we used the ECI for private industry workers in the executive and managerial group. For the period January 1, 1989 through December 31, 1992, the ECI percentage increase in compensation for executive and managerial employees employed in the private sector rose a combined 14.6 percent.

We compared the actual annual increases received by the executives to the ECI increases for each of the 4 years reviewed, and noted any excess. We then computed the effect of the excess compensation on the Medicare program using the same cost methodologies as used by the Medicare contractors. We must point out, however, that although we followed the same allocation method used by BCBSM, we recognize that BCBSM also arbitrarily made adjustments at the beginning and end of each year to "cap" costs in order to lower the cost per claim reported on the FACP. As a result of this practice, some costs, although allocated to the Medicare program, were not charged to the Medicare program. These uncharged costs cannot be specifically identified.

RESULTS OF REVIEW

UNREASONABLE COMPENSATION ALLOCATED TO MEDICARE

Comparing increases to executive compensation packages awarded to top executives at the three Medicare contractors to the ECI, we determined that the average increases exceeded the ECI at each of the contractors for each of the 4 years reviewed. As shown below, the total amount in excess of the ECI was over \$3.7 million.

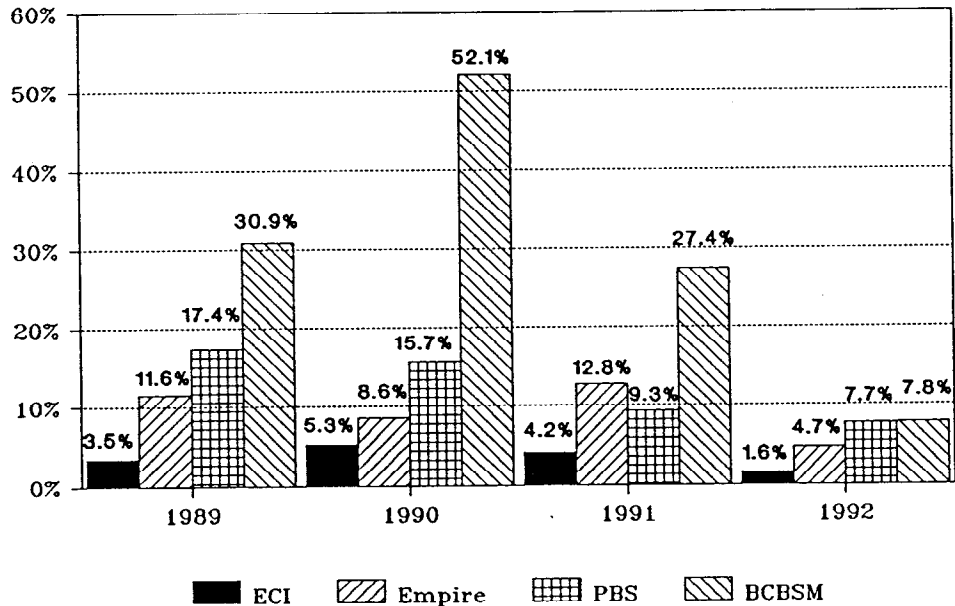
COMPENSATION INCREASES 1989-1992			
<u>Contractor</u>	<u>Actual Increase</u>	<u>Increase Per ECI</u>	<u>Excess</u>
BCBSM	\$1,878,769	\$ 185,016	\$1,693,753
Empire	2,477,459	896,327	1,581,132
PBS	<u>634,021</u>	<u>166,455</u>	<u>467,566</u>
Total	<u>\$4,990,249</u>	<u>\$1,247,798</u>	<u>\$3,742,451</u>

The Medicare program was allocated \$1,236,103 of the unreasonable increases. We believe it is the responsibility of the contractors to prevent such an occurrence. Regulations to which the contractors must adhere support the position that compensation charged to Medicare must be reasonable. Section 31.205-6(b) of the Federal Acquisition Regulation, which has been incorporated by specific reference in the Medicare contract, states, in part:

"Based upon an initial review of the facts, contracting officers or their representatives may challenge the reasonableness of any individual element or the sum of the individual elements of compensation paid or accrued to particular employees or classes of employees. In such cases there is no presumption of reasonableness and, upon challenge, the contractor must demonstrate the reasonableness of the compensation item in question."

The onus, therefore, is placed on the contractor to show that compensation is reasonable. However, the increases in executive compensation awarded during CYs 1989 through 1992 when compared to the ECI for the same period show that the increases in compensation were not reasonable.

Average Compensation Increase



Blue Cross and Blue Shield of Maryland

During the 4-year period of our review, the average annual compensation package of 12 of the highest paid executives at BCBSM rose from \$145,430 in the base year to \$301,994 in the final year, an increase of 107.7 percent. This increase was 93 percent higher than the ECI. The increases exceeded the ECI by \$1,693,753. The BCBSM allocated \$463,501 of the excessive compensation to the Medicare program.

We determined that all 12 executives had a portion of their compensation package allocated to the Medicare program. Four of these executives were eligible for increases for the full 4 years of our review, that is, they were employed in the same position from CYs 1988 through 1992; two executives were eligible for increases in 3 of the 4 years; four executives were eligible for increases for 2 of the 4 years, and two executives were eligible for increases in just 1 of the 4 years.

We found that 9 of the 12 executives received increases in each of the years that they were employed (2 executives did not

receive an increase in 1992 and 1 executive did not receive an increase in 1989). As shown below, the increases received by the executives exceeded the ECI in every year.

CY	EXECUTIVES	AVERAGE INCREASE (PERCENT)	ECI INCREASE (PERCENT)	PERCENT RANGE OF INCREASE	DOLLAR RANGE OF INCREASE	COMMENTS
1989	5 of 6	39.2	3.5	20.9 to 49.7	\$35,929 to \$104,639 average of \$66,496 per executive	The only executive not awarded an increase received increases in 3 subsequent years exceeding his base salary by a total of 67.9 percent.
1990	8	52.1	5.3	2.4 to 83.8	\$3,219 to \$318,089 average of \$95,949 per executive	There was only one executive whose increase did not exceed the ECI. The executive had received an increase of 44.5 percent in the previous year.
1991	9	27.4	4.2	12.0 to 56.1	\$22,441 to \$205,782 average of \$64,418 per executive	We noted that the executive that received an increase of 2.4 percent in CY 1990 received an increase of \$32,849 (23.9 percent) this year.
1992	7 of 9	10.8	1.6	5.7 to 27.9	\$13,292 to \$80,319 average of \$34,564 per executive	Two executives did not receive increases this year. However, one executive had received increases totaling 83.4 percent in the prior 3 years while the other executive had received increases of 129 percent in the prior 2 years.

In summary, the 12 executives' compensation packages examined during the period of review went from an average base year compensation package of \$145,430 to an average compensation

package of \$301,994 in the final year. This represents an average increase of 107.7 percent for the 12 executives.

We computed what the average increase in the executives' compensation packages would have been for the same period had the increases been limited to the ECI increases. As shown below, the average value of the executives' compensation packages would have been significantly less in each of the 4 years reviewed.

AVERAGE COMPENSATION PACKAGE				
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>
Actual	\$227,842	\$280,018	\$299,176	\$322,379
ECI	<u>180,170</u>	<u>167,149</u>	<u>160,146</u>	<u>162,709</u>
Excess	\$ 47,672	\$112,869	\$139,030	\$159,670

This increase in compensation is truly significant considering that two of the executives were employed only 2 of the 4 years and thus eligible for an increase in only 1 of the 4 years reviewed. For the four executives that were eligible for increases in the full 4 years, the increases averaged \$305,046 or 166 percent of their base year compensation. The table below shows increases in the compensation packages of two of the executives.

VALUE OF COMPENSATION PACKAGE		INCREASE IN VALUE (PERCENT)	INCREASE IF LIMITED TO ECI	COMMENTS
1988	1992			
\$275,000	\$862,005	213.5	\$1,507,130 less over 4-year period (CY 1989 through 1992)	Medicare allocation would have been \$111,474 less if increase limited to ECI.
\$172,921	\$613,944	250.0		Excess compensation allocated to the Medicare program totaled \$45,629. Incentive and other bonuses accounted for over \$300,000 or 54 percent of 1992 compensation.

Performance incentive payments and other bonuses accounted for a significant portion of executive compensation at BCBSM. In 1989, bonuses made up approximately 27 percent of total

compensation. By 1991, bonuses accounted for over 44 percent of the executives' total compensation.

In September 1992, BCBSM was the subject of hearings before the U.S. Senate's Permanent Subcommittee on Investigations of the Committee on Governmental Affairs concerning the financial viability of BCBSM. The Committee's investigative staff, as part of their review of BCBSM, examined the contractor's administrative costs. The staff, alarmed at the high level of administrative expenses at BCBSM, specifically highlighted the compensation packages of top executives. The staff noted in its testimony:

"Cost containment in terms of employee compensation does not appear to have been a priority among management at Blue Cross and Blue Shield of Maryland."

Testimony from the Maryland Insurance Commissioner reinforced the above statement:

"...the salary level and comparison package of the top executives of BCBSM was totally inconsistent with its charter as a nonprofit organization which is supposed to provide health care at the lowest possible cost to the largest possible segment of the population..."

Our review confirmed the excessive compensation structure of senior executives at BCBSM, and found that significant amounts of this compensation was allocated to the Medicare contract for reimbursement. We determined that the Medicare program was allocated \$463,501 in unreasonable compensation for executive salary increases in excess of the ECI for the CYs 1989 through 1992. However, due to BCBSM's practice of arbitrarily "capping" costs as previously explained, we cannot say with certainty that the allocated costs were actually charged to the Medicare program.

Pennsylvania Blue Shield

During the 4-year period of our review, the average compensation package of eight of the highest paid executives at PBS rose from \$139,979 to \$219,231, an increase of 56.6 percent. This increase was 42 percent higher than the ECI. The increases exceeded the ECI by \$1,242,348. The PBS allocated \$386,426 of the excessive compensation to the Medicare program.

We requested PBS to provide us information on the compensation of the 10 highest paid executives from CYs 1988 through 1992 so that we could determine the reasonableness of increases to their compensation packages in CYs 1989 through 1992. The PBS provided us the requested information showing wages received, wages deferred, and bonus payments for the 10 executives.

We determined that 9 of the 10 executives had a portion of their compensation package allocated to the Medicare program. Seven of these executives were eligible for increases for the full 4 years of our review, that is, they were employed in the same position from CYs 1988 through 1992. One executive was eligible for an increase in 3 of the 4 years, and one was eligible for an increase in just 1 of the 4 years.

We found that the executive who was eligible for an increase for only 1 of the 4 years--he was employed in CYs 1988 and 1989--did not receive an increase in CY 1989. The other eight executives received increases in each of the years that they were employed. As shown below, the increases received by these executives exceeded the ECI increases in every year with one exception--one employee received a 3.5 percent increase in CY 1991 versus the ECI increase of 4.2 percent.

CY	EXECUTIVES	AVERAGE INCREASE (PERCENT)	ECI INCREASE (PERCENT)	PERCENT RANGE OF INCREASE	DOLLAR RANGE OF INCREASE	COMMENTS
1989	7 of 8	17.4	3.5	6.1 to 34.4	\$9,639 to \$60,964 average of \$24,215 per executive	The only executive who was not awarded an increase was replaced in CY 1990.
1990	8	15.7	5.3	10.7 to 23.8	\$15,648 to \$62,537 average of \$25,218 per executive	
1991	8	9.3	4.2	3.5 to 14.1	\$9,095 to \$23,164 average of \$17,271 per executive	There was only one executive whose increase did not exceed the ECI increase. This executive had received increases of 30.2 percent and 23.8 percent in the 2 prior years.
1992	8	7.7	1.6	5.5 to 8.5	\$8,096 to \$25,924 average of \$15,576 per executive	We noted that the executive that received a 3.5 percent increase in CY 1991 received an increase of \$25,924 (7.7 percent) this year.

In summary, the eight executives who received increases during the period of review went from an average base year (CY 1988 for seven executives and CY 1989 for the other executive) compensation package of \$139,979 to an average compensation package of \$219,231 in the final year--CY 1992. This represents an average increase of 56.6 percent for the eight executives.

We computed what the average increase in the executives' compensation package would have been for the same period had the increases been limited to the ECI increases. As shown below, the average value of the executives' compensation packages would have been significantly less in each of the 4 years reviewed.

AVERAGE COMPENSATION PACKAGE				
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>
Actual	\$163,049	\$186,385	\$203,655	\$219,231
ECI	<u>143,694</u>	<u>151,875</u>	<u>158,254</u>	<u>160,786</u>
Excess	\$ 19,355	\$ 34,510	\$ 45,401	\$ 58,445

As shown above, the eight executives earned an average compensation far in excess of the ECI. The compensation increases of the eight executives is significant in terms of both percentages and dollars, however, some of the executives did far better than the averages would indicate. The table below shows increases in the compensation packages of two of the executives.

VALUE OF COMPENSATION PACKAGE		INCREASE IN VALUE (PERCENT)	INCREASE IF LIMITED TO ECI	COMMENTS
1988	1992			
\$201,634	\$362,468	79.8	\$396,675 less over 4-year period (CY 1989 through 1992)	Medicare allocation would have been \$112,998 less if increase limited to ECI.
\$101,568	\$195,734	92.7	\$225,371 less over 4-year period (CY 1989 through 1992)	Medicare allocation would have been \$47,100 less if increase limited to ECI.

In total, the eight executives' compensation packages were increased by \$1,242,348 more than the corresponding annual

increases to the ECI. Using the same method as used by PBS to allocate these costs to the Medicare program and other lines of business, we determined that the Medicare program was allocated \$386,426 of the excess compensation for these eight executives.

Empire Blue Cross and Blue Shield of New York

In June 1993, Empire, like BCBSM the year before, was the subject of Senate hearings involving its operations and financial solvency. The Senate Subcommittee's staff, as part of their review of administrative costs, offered the following conclusions on Empire's executive salary structure:

"...the top ten executives have been very good to themselves in awarding pay increases when compared to the rest of the work force at Empire. The compensation to the top ten executives has increased 56 percent since 1987 while the remaining 8,000 employees have received pay increases of only 27 percent since 1987."

and,

"At a time during which it has been losing subscribers, increasing its premiums and incurring staggering underwriting loses, the Plan made excessive expenditures for the benefit of its senior officers and the Board of Directors. Plan management authorized officer compensation, perks and fringe benefits as if the Plan were a profitable Fortune 500 company without regard for its not-for-profit status and whether such expenditures ultimately benefitted the Plan's subscribers."

In conjunction with our prior early alert memorandum, our review of the compensation packages of 60 Empire executives showed that the average annual compensation rose from \$107,816 in the base year to \$145,586 in the final year, an increase of 35 percent. This increase was 20.4 percent higher than the ECI. The increases exceeded the ECI by \$1,581,132. Empire allocated \$386,176 of the excessive compensation to the Medicare program.

We computed what the average increase in the executives' compensation package would have been for the same period had the increases been limited to the ECI increases. As shown below, the average value of the executives' compensation packages would have been significantly less in each of the 4 years reviewed.

AVERAGE COMPENSATION PACKAGE				
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>
Actual	\$120,275	\$129,914	\$146,697	\$145,586
ECI	<u>111,590</u>	<u>117,354</u>	<u>121,961</u>	<u>120,973</u>
Excess	\$ 8,685	\$ 12,560	\$ 24,736	\$ 24,613

As shown above, the Empire executives' earned, on the average, compensation packages well in excess of the ECI. While the average wages of the executives are significant in terms of both percentages and dollars, again, some of the executives did far better than the averages would indicate. The table below shows increases in the compensation packages of three of the executives.

VALUE OF COMPENSATION PACKAGE		INCREASE IN VALUE (PERCENT)	INCREASE IF LIMITED TO ECI	COMMENTS
1988	1992			
\$262,500	\$427,141	62.7	\$345,296 less over 4-year period (CY 1989 through 1992)	Medicare allocation would have been \$34,496 less if increase limited to ECI.
\$117,614	\$227,020	93.0	\$332,901 less over 4-year period (CY 1989 through 1992)	Medicare allocation would have been \$32,453 less if increase limited to ECI.
\$457,500	\$600,000	31.0	\$199,409 less over 4-year period (CY 1989 through 1992)	Medicare allocation would have been \$19,953 less if increase limited to ECI.

In total, the Empire executives' compensation packages were increased by \$1,581,132 more than the corresponding annual increases to the ECI. As a result, we determined the Medicare program was allocated \$386,176 of the excess compensation for the Empire executives reviewed.

CONCLUSIONS AND RECOMMENDATIONS

Our review of executive compensation at three nonprofit Blue Cross and Blue Shield Medicare contractors showed that they awarded their highest paying executives with increases to their compensation packages at a far higher rate than for executives employed in the private sector, as measured by the ECI for CYs 1989 through 1992. Using the ECI as the barometer for measuring the reasonableness of increases in compensation, we determined that the highest paid executives at the three Medicare contractors were awarded increases totaling over \$3.7 million more than ECI increases. The Medicare program was allocated over \$1.2 million of the excessive increases.

We do not believe that the Medicare program should be allocated increases to compensation that are excessive or unreasonable. These increases seem particularly inappropriate at a time when the Medicare trust funds are facing financial uncertainty.

In its 1994 annual report, the Board of Trustees of the Federal Hospital Insurance Trust Fund concluded that the Hospital Insurance trust fund is quickly approaching insolvency. The board predicted that the fund will be sufficient to ensure payment of benefits only over the next 7 years. The fund is expected to be exhausted, under most likely assumptions, in the year 2001.

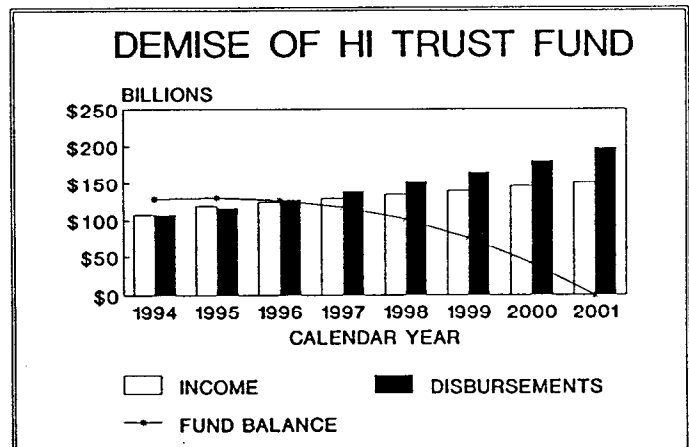


Figure 2

Although the Supplementary Medical Insurance trust fund is not facing the same immediate financial threat as is the Hospital Insurance trust fund, there is also concern about its financial status. The Board of Trustees of the Federal Supplementary Medical Insurance Trust Fund expressed concern in its 1994 annual report about the past and projected rapid growth in the cost of the program.

The Boards of both trust funds urged the Congress to promptly take actions to control program costs. We believe that paying program costs attributable to an item such as unreasonable and excessive executive compensation while the program is struggling to maintain the financial ability to pay for beneficiaries' medical services, should not be tolerated.

In light of our audit results at the three Medicare contractors and HCFA's interest, we are expanding our review of the reasonableness of executive compensation packages to other Medicare contractors. We are also developing an audit guide for use by nonfederal auditors who often audit the contractors' FACP. We believe that, although these audits will be an effective means of measuring the reasonableness of increases to executive compensation packages, HCFA should not rely on them totally nor rely on the good will of the contractors to keep compensation increases at a reasonable level.

Recommendation

We recommend that HCFA consider establishing a ceiling on executive compensation increases that Medicare contractors can allocate to the Medicare program. One method of implementing such a ceiling is to limit executive compensation increases to the ECI.

HCFA's Comments

The HCFA concurred with our conclusions and recommendation, however, believe extensive contract negotiations will need to take place before HCFA can unilaterally place a ceiling on executive salary increases, especially since the Medicare contracts are cost reimbursed agreements. The HCFA will inform contractors of their intention to limit salaries within the context of their current agreements. The HCFA also stated that limits on executive salary increases will be included as part of any renegotiated contracts that will be needed to implement the Medicare Transaction System.

The HCFA noted that there are methods other than the ECI that can be used to limit compensation at Medicare contractors, such as capping contractor salary increases at the annual cost of living increase which Federal employees receive, or holding fiscal intermediaries and carriers to the same contractual requirements as Peer Review Organizations.

OIG's Comments

We agree there exists other methodologies that can be used to place limits on executive salary increases. To assist HCFA in its contract negotiations, we will share with HCFA supporting documentation for this report.

In response to HCFA's additional comments, this report is a consolidation of the results of reviews of executive compensation at three Medicare contractors and has not been released for their individual comments. Therefore, individual contractor responses will not be included as part of this final report.

DEPARTMENT OF HEALTH & HUMAN SERVICES

**Memorandum**

JUL 20 1994

Date

From

Bruce C. Vladeck
Administrator

Subject

Office of Inspector General (OIG) Draft Report: "Review of Executive Compensation at Medicare Contractors," (A-03-94-00004)

To

June Gibbs Brown
Inspector General

We reviewed the subject draft report which finds that some Medicare contractors are allocating unreasonable executive compensation to the Medicare program.

The Health Care Financing Administration agrees with the report's recommendation to establish a ceiling on executive compensation increases. Additional comments are attached for your consideration.

Thank you for the opportunity to review and comment on this report. Please advise us if you would like to discuss our position on the report's recommendation at your earliest convenience.

Attachment

Comments of the Health Care Financing Administration (HCFA)
on the Office of Inspector General (OIG) Draft Report:
"Review of Executive Compensation at Medicare Contractors."
(A-03-94-00004)

OIG Recommendation

HCFA should consider establishing a ceiling on executive compensation increases that Medicare contractors can allocate to the Medicare program. One method of implementing such a ceiling is to limit executive compensation increases to the Employment Cost Index (ECI).

HCFA Response

We agree that Medicare should not be allocated unreasonable or excessive increases in executive compensation. Extensive contract negotiations, however, will need to take place before HCFA can unilaterally place a ceiling on executive salary increases, especially since the Medicare contracts are cost reimbursed agreements. We will inform contractors of our intention to limit salaries within the context of our current agreements. Also, limits on executive salary increases will be included as part of any renegotiated contracts that will be needed to implement the Medicare Transaction System.

We also agree that the ECI could be used as a comparative measure to determine unreasonable and excessive officers' compensation. However, there are methods other than the ECI that can be used to limit compensation at Medicare carriers and intermediaries. For example, capping contractor salary increases at the annual cost of living increase which Federal employees receive, or holding fiscal intermediaries and carriers to the same contractual requirements as Peer Review Organizations.

Additional Comments

We suggest that the report include the contractors' responses to the audit conclusions. As indicated in section 31.250-6(b) of the Federal Acquisition Regulation, upon challenge as to reasonableness the onus falls on the contractor to demonstrate the reasonableness of the compensation item in question. The report should include these demonstrations of reasonableness.

For clarity, we suggest changing the graphic's title on page 13 to "Demise of the HI Trust Fund."