



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Washington, D.C. 20201

FEB 20 2008

TO: Kerry Weems
Acting Administrator
Centers for Medicare & Medicaid Services

FROM: Daniel R. Levinson *Daniel R. Levinson*
Inspector General

SUBJECT: Review of Quality Improvement Organization in Washington (A-09-06-00039)

Attached is an advance copy of our final report on the Quality Improvement Organization (QIO) program in Washington. In each State, the Centers for Medicare & Medicaid Services contracts with QIOs, which were established to promote the effective, efficient, and economical delivery of Medicare health care services and the quality of those services. The Senate Finance Committee requested that the Office of Inspector General assess the fiscal integrity of the QIOs with respect to six specified subject areas. This report is one of a series of nine audits of QIOs that respond to that request. In Washington, Qualis Health was the QIO for the period November 1, 2002, through October 31, 2005. For this 3-year period, known as the seventh scope of work, Qualis Health received \$24.8 million in Federal reimbursement to perform the core contract and 11 special studies for the Washington QIO contract. We will issue this report to Qualis Health within 5 business days.

Our objective was to review the six fiscal integrity areas requested by the Senate Finance Committee. Specifically, we reviewed board member and executive staff compensation; board member and executive staff travel; costs relating to legal fees, including administrative charges; equipment and administrative charges; business relationships and conflicts of interest; and contract modifications.

We found that of the \$12.2 million of costs reviewed, \$12.1 million appeared reasonable for Federal reimbursement. The remaining \$73,636 represents unallowable indirect costs, which Qualis Health allocated to subcontracts in excess of the allowable limit.

In addition, Qualis Health overstated its (1) modified total direct costs (MTDC) bases by \$404,302 in total for fiscal years 2003 through 2005 by including subcontract costs in excess of the allowable \$25,000 per subcontract and (2) indirect cost pool by \$71,741 for fiscal year 2005 by including unallowable organization costs. These overstatements were reflected in the calculation of the proposed indirect cost rates and should be taken into account when finalizing the indirect cost rates.

We recommend that Qualis Health (1) refund the \$73,636 of unallowable indirect costs claimed on subcontracts and (2) reduce the MTDC allocation bases by \$404,302 in total for unallowable subcontract costs and the indirect cost pool by \$71,741 for unallowable organization costs when finalizing the indirect cost rates with the Centers for Medicare & Medicaid Services.

In written comments on the draft report, Qualis Health agreed with the finding related to unallowable indirect costs but disagreed with the amount of the recommended refund. Regarding the second finding and related recommendation, Qualis Health stated that it had adjusted the MTDC bases and the indirect cost pool and had provided revised indirect cost rate proposals to the Defense Contract Audit Agency.

Based on our evaluation of additional information provided by Qualis Health and the Defense Contract Audit Agency concerning the finalization of indirect cost rates, we revised our report to reflect a refund amount of \$73,636.

If you have any questions or comments about this report, please do not hesitate to call me, or your staff may contact George M. Reeb, Assistant Inspector General for the Centers for Medicare & Medicaid Audits, at (410) 786-7104 or through e-mail at George.Reeb@oig.hhs.gov or Lori A. Ahlstrand, Regional Inspector General for Audit Services, Region IX, at (415) 437-8360 or through e-mail at Lori.Ahlstrand@oig.hhs.gov. Please refer to report number A-09-06-00039 in all correspondence.

Attachment



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Region IX
Office of Audit Services
90 – 7th Street, Suite 3-650
San Francisco, CA 94103

FEB 25 2008

Report Number: A-09-06-00039

Jonathan Sugarman, M.D., M.P.H.
President and Chief Executive Officer
Qualis Health
10700 Meridian Avenue North
Seattle, Washington 98133

Dear Dr. Sugarman:

Enclosed is the U.S. Department of Health and Human Services (HHS), Office of Inspector General (OIG), final report entitled "Review of Quality Improvement Organization in Washington." We will forward a copy of this report to the HHS action official noted on the following page for review and any action deemed necessary.

The HHS action official will make final determination as to actions taken on all matters reported. We request that you respond to this 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.

Pursuant to the principles of the Freedom of Information Act, 5 U.S.C. § 552, as amended by Public Law 104-231, OIG reports generally are made available to the public to the extent the information is not subject to exemptions in the Act (45 CFR part 5). Accordingly, within 10 business days after the final report is issued, it will be posted on the Internet at <http://oig.hhs.gov>.

If you have any questions or comments about this report, please do not hesitate to contact me at (415) 437-8360 or through e-mail at Lori.Ahlstrand@oig.hhs.gov. Please refer to report number A-09-06-00039 in all correspondence.

Sincerely,

A handwritten signature in black ink, appearing to read "Lori A. Ahlstrand".

Lori A. Ahlstrand
Regional Inspector General
for Audit Services

Enclosure

Direct Reply to HHS Action Official:

James Randolph Farris, M.D., Consortium Administrator
Consortium for Quality Improvement and
Survey & Certification Operations
Centers for Medicare & Medicaid Services
1301 Young Street, Suite 714
Dallas, Texas 75202

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF QUALITY
IMPROVEMENT ORGANIZATION
IN WASHINGTON**



Daniel R. Levinson
Inspector General

February 2008
A-09-06-00039

Office of Inspector General

<http://oig.hhs.gov>

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THIS REPORT IS AVAILABLE TO THE PUBLIC
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Pursuant to the principles of the Freedom of Information Act, 5 U.S.C. § 552, as amended by Public Law 104-231, Office of Inspector General reports generally are made available to the public to the extent the information is not subject to exemptions in the Act (45 CFR part 5).

OFFICE OF AUDIT SERVICES FINDINGS AND OPINIONS

The designation of financial or management practices as questionable, a recommendation for the disallowance of costs incurred or claimed, and any other conclusions and recommendations in this report represent the findings and opinions of OAS. Authorized officials of the HHS operating divisions will make final determination on these matters.

EXECUTIVE SUMMARY

BACKGROUND

In the Medicare program, the Centers for Medicare & Medicaid Services (CMS) contracts with Quality Improvement Organizations (QIO) in each State. According to section 1862(g) of the Social Security Act, QIOs were established for “the purposes of promoting the effective, efficient, and economical delivery of health care services, and of promoting the quality of services”

QIOs submit vouchers to CMS for Federal reimbursement monthly. The vouchers and reimbursements include amounts for both direct and indirect costs. The QIOs determine the amount of indirect costs to claim by multiplying an indirect cost rate against their direct costs. During the contract period, CMS usually is unable to calculate an indirect cost rate. Therefore, the QIOs use provisional rates to determine indirect costs. After the close of each QIO’s fiscal year, the Defense Contract Audit Agency (DCAA) reviews the organization’s actual direct and indirect costs. The CMS contracting officer considers DCAA’s recommendations in establishing the final rate and performing the final cost settlement.

Qualis Health was the Washington QIO for the period November 1, 2002, through October 31, 2005. For this 3-year period, known as the seventh scope of work, Qualis Health received \$24.8 million in Federal reimbursement to perform the core contract and 11 special studies for the Washington QIO contract. During fiscal years (FY) 2003 through 2005 (October 1, 2002, through September 30, 2005), Qualis Health incurred total costs of approximately \$68.8 million to support all lines of business, including the QIO contracts for Washington, Idaho, and Alaska. At the completion of our fieldwork, CMS had not performed the final cost settlement for the seventh scope of work.

The Senate Finance Committee requested that the Office of Inspector General assess the fiscal integrity of the QIOs. The Senate Finance Committee requested that we review, at a minimum, the following areas:

1. board member and executive staff compensation;
2. board member and executive staff travel;
3. costs relating to legal fees, including administrative charges;
4. equipment and administrative charges;
5. business relationships and conflicts of interest; and
6. contract modifications.

OBJECTIVE

Our objective was to review the six fiscal integrity areas requested by the Senate Finance Committee.

SUMMARY OF FINDINGS

Of the \$12.2 million of costs reviewed, \$12.1 million appeared reasonable for Federal reimbursement. The remaining \$73,636 represents unallowable indirect costs, which Qualis Health allocated to subcontracts in excess of the allowable limit.

In addition, Qualis Health overstated its (1) modified total direct costs (MTDC) bases by \$404,302 in total for FYs 2003 through 2005 by including subcontract costs in excess of the allowable \$25,000 per subcontract and (2) indirect cost pool by \$71,741 for FY 2005 by including unallowable organization costs. These overstatements were reflected in the calculation of the proposed indirect cost rates and should be taken into account when finalizing the indirect cost rates.

RECOMMENDATIONS

We recommend that Qualis Health:

- refund the \$73,636 of unallowable indirect costs claimed on subcontracts and
- reduce the MTDC allocation bases by \$404,302 in total for unallowable subcontract costs and the indirect cost pool by \$71,741 for unallowable organization costs when finalizing the indirect cost rates with CMS.

QUALIS HEALTH'S COMMENTS AND OFFICE OF INSPECTOR GENERAL'S RESPONSE

In written comments on the draft report, Qualis Health agreed with the finding related to unallowable indirect costs but disagreed with the amount of the recommended refund. Regarding the second finding and related recommendation, Qualis Health stated that it had adjusted the MTDC bases and the indirect cost pool and had provided revised indirect cost rate proposals to DCAA.

Based on our evaluation of additional information provided by Qualis Health and DCAA concerning the finalization of indirect cost rates, we revised our report to reflect a refund amount of \$73,636.

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INTRODUCTION

BACKGROUND

Quality Improvement Organization Program

Part B of Title XI of the Social Security Act (the Act), as amended by the Peer Review Improvement Act of 1982, established the Utilization and Quality Control Peer Review Organization Program, now known as the Quality Improvement Organization (QIO) Program. Pursuant to section 1862(g) of the Act, QIOs were established to promote the effective, efficient, and economical delivery of Medicare health care services and the quality of those services.

Pursuant to 42 CFR § 475.101, “to be eligible for a QIO contract an organization must – (a) Be either a physician-sponsored organization . . . or a physician-access organization . . . and (b) Demonstrate its ability to perform review”

The Centers for Medicare & Medicaid Services (CMS) awards the contracts for 41 QIO organizations, which administer 53 QIO contracts (all 50 States plus the District of Columbia, Puerto Rico, and the U.S. Virgin Islands), every 3 years. Each contract requires a specific scope of work (SOW). Seven SOWs have been completed. The SOW for each contract may be modified to make adjustments to the contract tasks. Certain modifications, referred to as special studies, generally receive the majority of funding increases. Federal funding for QIOs was budgeted at approximately \$1.3 billion for the seventh SOW.

The Office of Management and Budget (OMB) Circular A-122, “Cost Principles for Non-Profit Organizations,” as revised June 1, 1998, and May 10, 2004, establishes the principles for determining allowable costs with respect to contracts with nonprofit organizations.¹

Claims for Federal Reimbursement

Pursuant to its contract with CMS, each QIO submits vouchers to CMS monthly. The vouchers include claims for both direct and indirect costs. Pursuant to OMB Circular A-122, Attachment A, direct costs are amounts “that can be identified specifically with a particular final cost objective” (section B.1), and indirect costs are amounts “that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective” (section C.1). An indirect cost rate is established for each contract and is generally calculated by dividing allowable indirect costs by all direct costs. The QIOs determine the amount of indirect costs to claim by multiplying an indirect cost rate against their direct costs.²

During the contract period, CMS usually is unable to calculate an exact indirect cost rate. Therefore, the QIOs use provisional rates to determine indirect costs. Pursuant to OMB Circular

¹Although OMB Circular A-122 was updated during the seventh SOW, the principles of the circular cited in this report did not change.

²Some of the direct costs, including passthrough costs, do not receive an allocation of indirect costs. Section G.3 of the QIO contract requires QIOs to exclude their passthrough costs in the calculation of indirect costs.

A-122, Attachment A, section E.1.e, a provisional rate is a temporary indirect cost rate “applicable to a specified period which is used for funding, interim reimbursement, and reporting indirect costs on awards pending the establishment of a final rate for the period.” After the close of a QIO’s fiscal year (FY), CMS contracts with the Defense Contract Audit Agency (DCAA) to review the indirect cost rate proposals, which contain the actual direct and indirect costs, and to make recommendations as to the final rates for that FY. The CMS contracting officer considers DCAA’s recommendations in establishing the final rate for each QIO.

Washington Quality Improvement Organization

Qualis Health, headquartered in Seattle, Washington, served as the QIO for Washington, Idaho, and Alaska for the period November 1, 2002, through October 31, 2005. Qualis Health is a nonprofit organization that was incorporated in 1979. Qualis Health’s contract with the Federal Government is a combination of a cost-plus-award-fee and a cost-plus-fixed-fee (completion form) contract.

For the 3-year period known as the seventh SOW (November 1, 2002, through October 31, 2005), Qualis Health received \$24.8 million in Federal reimbursement to perform the core contract and 11 special studies for the Washington QIO contract. During FYs 2003 through 2005 (October 1, 2002, through September 30, 2005), Qualis Health incurred total costs of approximately \$68.8 million to support all lines of business, including the QIO contracts.

For FY 2003, which covered part, but not all, of the seventh SOW, DCAA has reviewed the indirect cost rate and determined that Qualis Health’s indirect cost rate is acceptable as proposed. At the completion of our fieldwork, DCAA had not reviewed the indirect cost rates for FYs 2004 and 2005. However, after our draft report was issued, DCAA completed an audit of final incurred costs, allocable indirect costs, and indirect cost rates for FYs 2004 and 2005. The CMS contracting officer will consider both DCAA’s and our recommendations in establishing the final rates and settling the cost differences between the provisional and final rates for the seventh SOW.

Senate Finance Committee Request

The Senate Finance Committee requested that the Office of Inspector General review the fiscal integrity of the QIOs. The Senate Finance Committee requested that we review, at a minimum, the following areas:

1. board member and executive staff compensation;
2. board member and executive staff travel;
3. costs relating to legal fees, including administrative charges;
4. equipment and administrative charges;
5. business relationships and conflicts of interest; and
6. contract modifications.

The Senate Finance Committee also expressed concern about the extent to which QIOs addressed beneficiaries' quality-of-care concerns and the beneficiary complaint resolution process. We have examined those issues in another review (OEI-01-06-00170).

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

Our objective was to review the six fiscal integrity areas requested by the Senate Finance Committee.

Scope

We reviewed a judgmental sample of \$12,222,788 (\$12.2 million) of the costs that Qualis Health incurred for the seventh SOW (November 1, 2002, through October 31, 2005). In total, Qualis Health received \$24.8 million in Federal reimbursement for the Washington core QIO contract and 11 special studies.

The \$12.2 million consisted of costs incurred for the six areas that the Senate Finance Committee requested we review. We reviewed these costs to determine whether they were (1) reasonable, allowable, and allocable under the terms of the contract and (2) supported by accounting records and other reliable documentation.

We limited our internal control review to Qualis Health systems and procedures for claiming costs to the extent necessary to accomplish our objective.

Our audit was intended to supplement information contained in DCAA audits.

We performed fieldwork at Qualis Health's office in Seattle, Washington.

Methodology

We took the following actions to accomplish our objectives:

- We reviewed applicable Federal requirements.
- We interviewed Qualis Health officials and reviewed Qualis Health policies and procedures to obtain an understanding of how Qualis Health claimed costs for Federal reimbursement.
- We interviewed the CMS project officer at the CMS regional office to obtain an understanding of CMS's role in the contracting process.
- We reconciled the Federal reimbursement, in total (as indicated on the vouchers that Qualis Health submitted to CMS), to Qualis Health's general ledger to determine the costs Qualis Health incurred and charged to the contract.

- We examined, on a test basis, evidence supporting the \$12.2 million of costs included in our review and claimed by Qualis Health. For each of the six areas reviewed, we identified the general ledger accounts that contained the expenses that Qualis Health incurred during the seventh SOW.
 - For board member and executive staff compensation, we examined how frequently meetings were held, the rate used to pay the board members, and the number of board members who attended the meetings. We compared compensation for the board members to the amounts included in Qualis Health's proposal to CMS and the amounts approved by CMS. Because CMS eliminated salary ceilings for QIO executives after the fifth SOW, CMS no longer prescribes specific salary limitations. Accordingly, the general standards for reasonableness in executive salaries, as established by OMB Circular A-122, are applicable. To apply this standard, we analyzed the salary levels incurred by Qualis Health and tested the reasonableness of executive staff compensation.
 - For board member and executive staff travel, we analyzed documentation to determine whether transportation costs of board members and high-ranking executives were reasonable. We reviewed judgmentally selected trips to determine whether Qualis Health claimed transportation, hotel, and meal costs pursuant to Federal guidelines.
 - For costs relating to legal fees, including administrative charges, we reviewed legal fees and other costs associated with the acquisition of an information technology consulting company to determine whether the costs were reasonable and allowable for Federal reimbursement.
 - For equipment and administrative charges, we analyzed documentation to determine whether the incurred costs were allowable for Federal reimbursement.
 - For business relationships and conflicts of interest, we reviewed selected subcontracts, including payments made to other QIOs and for temporary workers. In addition, we reviewed selected conference costs and registration fees at selected conferences. We then analyzed the documentation to determine whether the incurred costs were reasonable and allowable for Federal reimbursement.
 - For contract modifications, we reviewed the modifications to determine whether they increased the funding for the seventh SOW, added a special study, or were technical in nature. For modifications that added special studies, we reviewed the objectives of the studies to determine whether they were approved by CMS and consistent with CMS's overall objectives for the seventh SOW.
- We assessed Qualis Health's accounting policies and procedures related to the capitalizing, expensing, and safeguarding of fixed-asset purchases.

- We reviewed DCAA audit reports of direct and indirect costs for FYs 2002 and 2003 to determine whether they included questioned costs applicable to the six fiscal integrity areas and to determine the status of the indirect cost rates.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

FINDINGS AND RECOMMENDATIONS

Of the \$12.2 million of costs reviewed related to the six fiscal integrity areas requested by the Senate Finance Committee, \$12.1 million appeared reasonable for Federal reimbursement.³ The remaining \$73,636 represents unallowable indirect costs, which Qualis Health allocated to subcontracts in excess of the allowable limit.

In addition, Qualis Health overstated its (1) modified total direct costs (MTDC) bases by \$404,302 in total for FYs 2003 through 2005 by including subcontract costs in excess of the allowable \$25,000 per subcontract and (2) indirect cost pool by \$71,741 for FY 2005 by including unallowable organization costs. These overstatements were reflected in the calculation of the proposed indirect cost rates, and we recommend that the overstatements be taken into account when finalizing the indirect cost rates.

UNALLOWABLE INDIRECT COSTS

Qualis Health improperly applied the provisional indirect cost rate to \$404,302 of direct subcontract costs.

Pursuant to OMB Circular A-122, Attachment A, section D.3.f:

Indirect costs shall be distributed to applicable sponsored awards and other benefitting activities within each major function on the basis of MTDC. MTDC consists of all salaries and wages, fringe benefits, materials and supplies, services, travel, and subgrants and subcontracts up to the first \$25,000 of each subgrant or subcontract (regardless of the period covered by the subgrant or subcontract). Equipment, capital expenditures, charges for patient care, rental costs and the portion in excess of \$25,000 shall be excluded from MTDC.

Qualis Health's indirect cost rate was based on the MTDC, which should include only the first \$25,000 of direct costs of each subcontract. When claiming indirect costs, however, Qualis Health included in its MTDC \$404,302 of subcontract costs in excess of the allowable \$25,000 per subcontract.

³The overstatement of the modified total direct cost bases and the indirect cost pool may result in additional adjustments to allowable costs.

After we issued our draft report, DCAA approved the final indirect cost rates for FYs 2004 and 2005. By applying the approved final indirect cost rates to the \$404,302 of direct subcontract costs that were improperly included in the MTDC bases, Qualis Health claimed \$73,636 of unallowable indirect costs during the seventh SOW.

OVERSTATED DIRECT COST BASES AND INDIRECT COST POOL

When calculating the proposed indirect cost rates, Qualis Health overstated its (1) MTDC bases by \$404,302 for FYs 2003 through 2005 by including subcontract costs in excess of the allowable \$25,000 per subcontract and (2) indirect cost pool by \$71,741 for FY 2005 by including unallowable organization costs.

Overstated Modified Total Direct Cost Bases

Pursuant to OMB Circular A-122, Attachment A, section D.3.f, the MTDC consists of subcontract costs up to the first \$25,000 of each subcontract (regardless of the period covered).

Qualis Health's proposed indirect cost rates were based on the MTDC, which should include only the first \$25,000 of direct costs of each subcontract. Contrary to Federal requirements, Qualis Health included in its MTDC \$404,302 of subcontract costs in excess of the allowable \$25,000 per subcontract. Of the \$404,302, \$20,000 was included in FY 2003, \$26,329 in FY 2004, and \$357,973 in FY 2005.

Overstated Indirect Cost Pool

Pursuant to OMB Circular A-122, Attachment A, section A.4.a:

A cost is allocable to a particular cost objective, such as a grant, contract, project, service, or other activity, in accordance with the relative benefits received. A cost is allocable to a Federal award if it is treated consistently with other costs incurred for the same purpose in like circumstances and if it:

- (1) Is incurred specifically for the award.
- (2) Benefits both the award and other work and can be distributed in reasonable proportion to the benefits received, or
- (3) Is necessary to the overall operation of the organization, although a direct relationship to any particular cost objective cannot be shown.

Contrary to Federal requirements, Qualis Health included \$71,741 of unallocable costs in its indirect cost pool, which was used in the calculation of the proposed FY 2005 indirect cost rate. Specifically, Qualis Health incurred \$71,741 of indirect costs pertaining to the acquisition of an information technology consulting company during FY 2005. The \$71,741 consisted of \$56,494 incurred for legal fees, \$13,896 of financial costs, and \$1,351 of travel and other costs that Qualis Health identified as costs associated with the acquisition of the consulting company. The

costs did not benefit the QIO contract and were not necessary to its overall operations as the QIO for the State of Washington. Therefore, these costs were unallocable.

RECOMMENDATIONS

We recommend that Qualis Health:

- refund the \$73,636 of unallowable indirect costs claimed on subcontracts and
- reduce the MTDC allocation bases by \$404,302 in total for unallowable subcontract costs and the indirect cost pool by \$71,741 for unallowable organization costs when finalizing the indirect cost rates with CMS.

QUALIS HEALTH'S COMMENTS

In written comments on the draft report (included in their entirety as the Appendix), Qualis Health agreed with the finding related to unallowable indirect costs but disagreed with the amount of the recommended refund. It stated that it had fully instituted accounting processes and control procedures to prevent such errors in the future. Regarding the second finding and related recommendation, Qualis Health stated that it had adjusted the MTDC bases and the indirect cost pool and had provided revised indirect cost rate proposals to DCAA.

Qualis Health stated that DCAA recently completed an audit of final incurred costs, allocable indirect costs, and indirect cost rates for FYs 2004 and 2005. Based on the recent adjustments to the MTDC bases and the DCAA-confirmed final indirect cost rates for those FYs, Qualis Health stated that the unallowable indirect costs would be reduced from \$122,140 (the refund amount in our draft report) to approximately \$74,000 for the Washington QIO contract. However, Qualis Health stated that, when taking into account its QIO contracts for Idaho and Alaska, the actual net amount at issue would be approximately \$46,000. Further, Qualis emphasized that a \$46,000 adjustment “will simply result in a reduction in the final 7th SOW payment due to Qualis Health from the Government.”

OFFICE OF INSPECTOR GENERAL'S RESPONSE

Based on our evaluation of additional information provided by Qualis Health and DCAA concerning the finalization of indirect cost rates, we revised our report to reflect a reduction of the recommended refund amount from \$122,140 to \$73,636. Because we audited only the Washington QIO contract, the findings and recommendations in our report apply only to that contract.

APPENDIX



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October 11, 2007

Lori A. Ahlstrand
Regional Inspector General for Audit Services
Office of Inspector General
Region IX
Office of Audit Services
90-7th Street, Suite 3-650
San Francisco, CA 94103

Dear Ms. Ahlstrand:

Qualis Health appreciates the opportunity to provide comments regarding the Draft OIG Audit Report Number A-09-06-00039, Review of Quality Improvement Organization in Washington, dated September 13, 2007 ("Draft Audit Report"). Qualis Health's mission is to generate, apply, and disseminate knowledge to improve the quality of healthcare delivery and health outcomes. In implementing this mission, Qualis Health emphasizes adherence to the highest standards of organizational integrity. We believe that external scrutiny, such as that reflected in the OIG audit, adds great value to our efforts to continuously improve our organization.

This letter provides four specific comments on various aspects of the Draft Audit Report, and makes some suggestions for the inclusion of additional language to enhance the Report's clarity. Before setting forth these four specific comments, we provide some background as to the audit itself and the main finding of same.

The Draft Audit Report resulted from an extensive audit of Qualis Health conducted by your office from May 2006 through September 2007. During the 5-month field audit period that began in May 2006, up to five auditors conducted reviews on-site in our Seattle office, supplemented by additional work in your Los Angeles and San Diego offices. During this time period, we provided your staff with over 12,000 pages of hard copy documents, and submitted for review an extensive set of electronic files. The fact that Qualis Health incurred over \$170,000 in costs to support the audit reflects the significant effort Qualis Health invested in meeting the needs and requests of your auditors. We appreciated the thorough work conducted by your auditors, as the audit confirmed that Qualis Health conformed with all requirements in the vast majority of the areas you reviewed, including requirements regarding reasonableness, allowability, and allocability of charges, and with expectations in a number of areas related to organizational integrity.

During the three year period (November 1, 2002 through October 31, 2005, known as the 7th Scope of Work, or 7SOW), Qualis Health received \$24.8 million in Federal reimbursement for the Washington Medicare Quality Improvement Organization (QIO) contract. During that period, Qualis Health incurred total costs of \$68.8 million to support all lines of business. These costs included \$10.8 million for 7SOW QIO contracts for Idaho and Alaska.

You reported that, as a result of the intensive, non-random review of an extensive “judgmental sample” conducted by your auditors for this three year period, the auditors identified \$122,140 in unallowable subcontract costs, 95 percent of which were associated with a single systematic error in accounting practice that occurred in FY-2005. This “judgmental sample” of \$12.2 million represented nearly half of all costs incurred under the Washington QIO contract. The Draft Audit Report reported that approximately 99% of the costs reviewed were reasonable for federal reimbursement (\$12.1 million of the \$12.2 million sampled). Because the audit sample was not random, and excluded areas not likely to be questioned, it is nearly certain that reasonable charges for the entire contract were even greater than 99%. The questioned costs represent less than 0.5% of costs incurred for the Washington QIO contract. As described more fully below, we believe that the impact of implementing all of the recommendations of the Draft Audit Report will further reduce the amount at issue.

With respect to specific content of the Draft Audit Report, we provide the following comments and requests for changes or additions:

1. In addition to the areas related to indirect costs addressed in the Draft Audit Report, pages i and 2 of the report expressly identify a number of other areas that the audit explicitly focused on at the request of the Senate Finance Committee. These include:
 - board member compensation
 - executive staff compensation
 - board member travel
 - executive staff travel
 - equipment charges
 - business relationships
 - conflicts of interest
 - contract modifications

In fact, the audit expressly focused a majority of its efforts on an in-depth examination of the areas specified above. The Draft Audit Report, however, does not explicitly state that the OIG auditors made no findings with respect to the areas listed above. We request that the Draft Audit Report be amended to contain an explicit statement that the auditors made no findings in these areas.

2. The Draft Audit Report identifies \$122,140 in unallowable indirect costs claimed on subcontracts under the 7SOW. Of the \$122,140, \$6,042 were charged in FY

2003, \$7,954 were charged in 2004, and \$108,144 (95%) were charged in FY 2005. We agree with the OIG findings related to charges for indirect costs of subcontracts that exceed \$25,000, and we have now fully instituted accounting processes and control procedures that will prevent such errors in the future. Specifically, we have completely revised our subcontracting process, and instituted a series of checks and balances to eliminate those parts of the process that resulted in the errors identified by OIG. For instance, some of the charges identified by OIG were associated with contract modifications that were interpreted as new contracts by accounting staff, and by changes in vendor name in the midst of contracts that were not recognized by accounting staff as continuation of the same contracts.

3. Although we do not challenge the basis for the finding regarding unallowable indirect costs, Qualis Health does have some concern that the Draft Audit Report as written could lead to confusion as to the amount at issue. The first of these concerns relates to potential confusion regarding the total net impact on charges to the government associated with OIG's findings. The Draft Audit Report identifies \$122,140 in unallowable indirect costs claimed on subcontracts and recommends that Qualis Health repay this amount. In addition, however, the Draft Audit Report also recommends a \$404,302 change in modified total direct costs (MTDC) bases and proposes a reduction of \$71,741 in the indirect cost pool. As the OIG auditors understand, these last two recommendations do not reflect liabilities in addition to the \$122,140, but the language used in the Draft Audit Report could lead the casual reader and the public to conclude otherwise. Qualis Health requests that the Draft Audit Report be revised to make it clear that reductions to the MTDC and the indirect cost pool do not amount to further liabilities to the Medicare Program, or further findings of unallowable costs.

The second concern Qualis Health has with the Draft Audit Report's description of the \$122,140 concerns the Report's failure to note that the adoption of all of OIG's recommendations regarding the MTDC cost bases will in fact significantly reduce the amount of costs at issue from \$122,140 to approximately \$74,000 for the Washington QIO contract. This \$48,000 decrease is the effect of the Draft Audit Report finding results from the fact that allocable indirect costs are spread across a reduced cost base (due to the MTDC cost base adjustment), reducing the denominator for the indirect rate calculation. The adjustments have been made and were reflected in revised incurred submittals provided to the Defense Contract Audit Agency (DCAA). DCAA has recently completed an audit of FY 2004 and 2005, and has provided confirmation of the final incurred costs, allocable indirect costs, and indirect cost rate for each year, including the \$48,000 increase in indirect costs allocable to the Washington 7SOW contract for FY 2003-2005.

In addition, the MTDC correction and the resulting change on the indirect cost rate increases the indirect costs allocable to the Idaho and Alaska 7SOW contracts by a total of approximately \$28,000. Thus the correction of the MTDC cost base

has the effect of increasing reimbursable costs under all federal contracts. Qualis Health believes the Draft Audit report should acknowledge the fact that the actual amount due to the Program will be significantly less than the \$122,140 amount currently reflected in the Report. The actual amount at issue for the Washington QIO contract would be \$74,000, and an additional \$28,000 will be due to Qualis Health under the Alaska and Idaho QIO contracts, making the net amount at issue approximately \$46,000. Under separate cover, we have provided the data and calculations that reflect the actual financial impact of adopting the Draft Audit Report's recommendations.

4. The Draft Audit Report recommends that Qualis Health "refund" \$122,140 of unallowable indirect costs. As noted above, the actual amount will be approximately \$46,000. In fact, however, no refund would occur in this situation. Rather, the \$46,000 adjustment will simply result in a reduction in the final 7th SOW payment due to Qualis Health from the Government. Based on the recent DCAA audit of incurred costs for FY 2004 and 2005, as well as contract retentions on progress billings, we can now estimate that CMS will owe Qualis Health approximately \$330,000 at contract closeout. Contract retentions are routinely held back pending routine closeout audits. In addition to routinely withholding payment for the final voucher, which reflects work completed in the last month of the contract, CMS also withholds additional funds from all QIO contracts in anticipation of required reconciliations such as those recommended by OIG. We request that this fact be included in the report. Of note, because of the OIG audit, Qualis Health's routine DCAA closeout audit was delayed. Thus, over 95% of the incurred costs questioned by OIG were incurred in a period that had not yet undergone routine audits by DCAA prior to the OIG audit.

Thank you for the opportunity to provide comments to the Draft Audit Report. We respectfully request that you make the changes requested above. Please be assured that Qualis Health has aggressively, rapidly, and definitively addressed the issues identified in the audit. We remain committed to adhering to the highest standards of organizational integrity, and will continue to strive for perfection rather than mere excellence in the areas examined by the OIG.

Sincerely,



Jonathan R. Sugarman, MD, MPH
President and CEO