DEPARTMENT **OF HEALTH & HUMAN SERVICES**

Office of Inspector General
Office of Audit Services

REGION IV
Room 3T41
61 Forsyth Street, S.W.
Atlanta, Georgia 30303-8909

JUL 31 2002

CIN: A-04-99-05561

Mr. Michael Cascone, Jr.
Chairman of the Board and Chief Executive Officer
Blue Cross Blue Shield of Florida
4800 Deerwood Campus Parkway
Jacksonville, Florida 32246-8273

Dear Mr. Cascone:

Enclosed are two copies of the Department of Health and Human Services (HHS), Office of Inspector General (OIG), Office of Audit Services' (OAS) report entitled, *Audit of Medicare Administrative Costs Claimed by Blue Cross Blue Shield of Florida for Fiscal Years 1995 Through 1998.* A copy will be forwarded to the action official noted below for review and any action necessary.

Final determination as to actions taken on all matters reported will be made by the HHS action official. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing in the final determination.

In accordance with the principles of the Freedom of Information Act, 5 U.S.C. 552, as amended by the Public Law 104-231, OIG, OAS reports issued to the Department's grantees and contractors are made available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR part 5.). As such, within 10 business days after this final report is issued, it will be posted on the world wide web at http://oig.hhs.gov.

To facilitate identification, please refer to Common Identification Number A-04-99-05561 in all correspondence relating to this report. If you have any questions, please call me or Pete Barbera of my staff, at (404) 562-7758.

Sincerely yours,

Charles J. Curtis
Regional Inspector General
for Audit Services, Region IV

Enclosures – as stated

Direct Reply to HHS Action Official
Mr. Dale Kendrick
Associate Regional Administrator
Centers for Medicare & Medicaid Services
U.S. Department of Health and Human Services
Sam Nunn Atlanta Federal Center
61 Forsyth Street S.W., Suite 4T20
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Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

AUDIT OF MEDICARE ADMINISTRATIVE COSTS CLAIMED BY BLUE CROSS BLUE SHIELD OF FLORIDA FOR FISCAL YEARS 1995 THROUGH 1998

JANET REHNQUIST
Inspector General

JULY 2002
A-04-99-05561

EXECUTIVE SUMMARY

BACKGROUND

The Centers for Medicare & Medicaid Services (CMS) administers the Medicare fee-for service program by contracting with private organizations (usually insurance companies) to process and pay claims for services provided to Medicare beneficiaries. The CMS has contracted with Blue Cross Blue Shield of Florida (the Contractor), either directly or through the Blue Cross Blue Shield Association, to serve as a fiscal intermediary (FI) and carrier to process and pay Medicare Part A and Part B claims for services provided in the State of Florida.[1] The CMS has also contracted with the Contractor to serve as a Common Working File (CWF) host site.

During the period of our audit, Fiscal Years (FY) 1995 through 1998, the Contractor claimed $371,911,540 in administrative costs for reimbursement by CMS. This includes claimed costs of $72,468,919 for FI costs and $299,442,621 for carrier costs (includes the CWF costs).

OBJECTIVE

The objective of our review was to evaluate the reasonableness and allowability of costs claimed for reimbursement by the Contractor on its Final Administrative Cost Proposals (FACP) for the period October 1, 1994 through September 30, 1998.

During the audit we experienced difficulties with the Contractor in obtaining information needed to conduct our audit. For example, supporting documentation related to sampled invoices was not provided, or not provided timely, nor were we provided unrestricted access to the Contractor's cost allocation system in a timely manner. Consequently, we were unable to complete our audit as initially scheduled. Appendix D offers more details of the difficulties we encountered. In the testing that we were able to perform, we noted several problems (see Summary of Findings below). As a result, we were not able to obtain reasonable assurance that the Contractor's indirect cost allocations to Medicare, as well as some of the direct costs charged to Medicare for FY 1998, were allowable.

Because of our inability to obtain reasonable assurance regarding a portion of FY 1998 costs as well as other problems identified, we determined that extensive testing in the other years would be necessary. Given the issues encountered while performing our FY 1998 tests, we did not believe our results would be materially different by conducting tests of costs claimed in FYs 1995 through 1997. Moreover, the level of testing necessary for the other years could not be completed in a reasonable period of time. Consequently, we have set aside for CMS resolution (a) most indirect costs claimed and some direct costs in FY 1998 and (b) all indirect costs and some direct costs claimed by the Contractor for the other 3 FYs.

[1]Throughout this report, "Med A" refers to the FI contract and "Med B" refers to the carrier contract.

SUMMARY OF FINDINGS

We identified $5,158,255 of unallowable charges to the Medicare program, set aside $104,836,580 for CMS resolution, and did not audit $13,246,020 in pension-related costs. Because of the difficulties encountered in testing the FY 1998 costs (as discussed in Appendix D) and our inability to obtain reasonable assurance regarding the sampled costs for FYs 1997 and 1998, we have limited our unallowable charges to FYs 1997 and 1998 costs claimed.

We also identified several areas where improvements in the Contractor's internal controls and cost allocation system are needed.

Based on the work we were able to perform, we recommend that the Contractor reduce its current claims by the $5,158,255 as detailed below:

- The Contractor did not provide adequate documentation to support the allowability of costs to Medicare ($2,042,824).
- The Contractor did not support discrepancies between internal accounting records and the FACP ($406,637).
- The Contractor claimed unallowable lobbying costs ($89,310).
- The Contractor claimed expenses that did not benefit the Medicare program ($360,739).
- The Contractor's cost allocation system did not always allocate costs in accordance with Federal Acquisition Regulations which resulted in cost being allocated to Medicare that exceeded the benefit to Medicare ($2,021,798).
- The Contractor did not properly reverse certain accruals ($203,323).
- The Contractor claimed travel costs in excess of Federal Travel Regulation (FTR) limits ($33,624).

Of the $104,836,580 set aside for CMS resolution, we set aside $20,101,368 in FY 1998 costs because: (1) we did not receive requested documentation; (2) we had limitations placed on our access to the Contractor's FACP allocation system; and (3) we noted inappropriate or unallowable costs in the documentation that we were able to review. Additional FY 1998 costs were set aside for other reasons. These costs included $7,646,165 in section 208 issues, $680,044 in an FACP adjustment, and $216,408 in executive compensation for a total 1998 set aside amount of $28,643,985. The remaining $76,192,595 was based on the application of 1998 disallowance ratios or actual cost disallowances applied to the other years in our audit period. For a complete detail of this breakdown please refer to Appendix C. The following is a description of the total set aside amounts by classification:

- Chargebacks[2] ($49,194,976)
- Indirect costs other than chargebacks ($39,500,384)
- Return on Investment costs ($7,137,670)
- Section 208 issues[3] ($7,646,165)
- An FACP adjustment ($680,044)
- Executive compensation ($677,342)

We have included the Contractor's response to our draft report in its entirety in Appendix F.

Recommendations

We recommend that the Contractor reduce its claim by $5,158,255, which represents the unallowable costs we identified.

To settle $88,695,359 ($49.2 and $39.5 million above) of the $104,836,580 in costs set aside for CMS resolution, we recommend that the Contractor develop an equitable methodology for allocating costs to Medicare. The results from the establishment of this equitable allocation methodology would address nearly all of the set aside costs, as well as reduce the level of audit effort on the part of the Contractor and the auditors for similar audits in the future.

We also recommend that the Contractor develop an indirect cost allocation methodology, either by a systematic allocation basis or by an indirect cost rate, which results in the allocation of only the appropriate costs to the Medicare program. Also, we recommend the Contractor make the following improvements to its internal control structure and cost allocation system:

- Design and implement procedures for the reconciliation of costs allocated to Medicare from Contractor accounting records to detect and prevent improper allocations.
- Modify its cost allocation base to include non-Medicare costs so proper allocations will occur.
- Allocate internal audit costs using project time as the allocation basis.
- Modify the current methodology to consider differences in allocation rates between the time of the accrual and reversal.
- Allocate all lobbying costs as well as costs that do not benefit Medicare to a cost center that is not allocated to Medicare.
- Design and implement procedures to ensure that costs are included in the proper period.

[2]A chargeback is an indirect cost allocated to recipients based on some estimation of resources used by the recipient. For example, building costs may be charged back based on square footage used by the recipient.

[3]Section 208 issues refers to the HHS and Related Agencies Appropriation Act of 1993 that states that "Funds provided in this Act...may be used for one-year contracts which are to be performed in two fiscal years...." Section 208 as used here refers to issues regarding the proper period for claiming a cost.

- Ensure that travel policies and procedures are followed and correct its procedures to limit claimed travel costs to FTR limits.

We recommend that the Contractor submit the necessary substantive documentation to the CMS Contracting Officer to properly document the allowability as well as the allocability of costs set aside in this audit. In our opinion, if proper documentation is not received then set aside costs should be disallowed.

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Introduction

BACKGROUND

Medicare is the nation's largest health insurance program and covers over 39 million Americans. Medicare provides insurance to people age *65* and over, those who have permanent kidney failure, and certain people with disabilities. Medicare coverage is split into Part A and Part B. Medicare Part A helps pay for care in hospitals, skilled nursing facilities, hospice, and some home health care. Medicare Part B helps pay for doctors, outpatient hospital care, and some other medical services that Part A does not cover, such as the services of physical and occupational therapists, and other health services.'

The Centers for Medicare & Medicaid Services (CMS) administers the Medicare program by contracting with private organizations, usually insurance companies, to process and pay claims for services provided to Medicare beneficiaries.[2] The contracts provide for reimbursement of allowable administrative costs incurred by contractors. Such administrative costs include the direct costs of administering the contract as well as allocations of certain indirect costs of services or assets used by Medicare and other entities. Contractors claim reimbursement of administrative costs through submission to CMS of a Final Administrative Cost Proposal (FACP).

The Contractor has contracted with CMS as a fiscal intermediary (FI) and carrier to process and pay Medicare Part A and Part B fee-for-service claims in the State of Florida, as well as performing related services such as provider education and the Medicare Integrity Program.[3] The Contractor also contracts with CMS as a Common Working File (CWF)[4] host site. For the period October 1, 1994 through September 30, 1998 (Fiscal Year (FY) 1995 through FY 1998), the Contractor claimed for reimbursement total administrative costs of $371,911,540 as follows:

FY	1995	1996	1997	1998	Total
Med A	$16,172,195	$16,733,337	$19,810,152	$19,753,235	$72,468,919
Med B	$75,885,960	$78,001,589	$71,653,898	$73,901,174	$299,442,621
Total	$92,058,155	$94,734,926	$91,464,050	$93,654,409	$371,911,540

[1]For more information on Medicare, see the Medicare web page at http://www.medicare.gov/basics/whatis.asp

[2]The CMS is an agency of the Department of Health and Human Services. For more information on CMS, see its web page at **http://CMSgov/medicare/incardir.htm.**

[3] The Contractor established First Coast Service Options (FCSO) as a wholly owned subsidiary to administer its Medicare fee-for-service contracts. The FCSO began operations on January 1, 1999. The Contractor has a pending request to CMS for notation of these contracts to FCSO.

[4]The CWF is a claims validation system that verifies Medicare eligibility at the time that the bill is submitted for payment. Eligibility must be determined prior to payment.

Independent auditors under contract with the Office of Inspector General (OIG) last performed an administrative cost audit at the Contractor for costs claimed for FYs 1987 through 1990. For FYs 1991 through 1994, CMS performed a risk assessment to settle those years.

OBJECTIVE

The objective of our review was to evaluate the reasonableness and allowability of costs claimed for reimbursement by the Contractor on its FACPs for the period October 1, 1994 through September 30, 1998.

SCOPE

Our audit covered the period of October 1, 1994 through September 30, 1998 and was conducted in accordance with generally accepted government auditing standards (GAGAS).

In performing this audit, our general approach (with concurrence from Contractor officials) was to initially test internal controls and a judgmental sample of invoices for direct and indirect costs claimed in FY 1998. We would then consider those results to determine the level of testing necessary to obtain reasonable assurance that costs claimed by the Contractor in the other relevant years were allowable. This approach as it relates to indirect and some direct costs, however, was negated by actions of Contractor officials.

Throughout the course of this audit, Contractor officials did not provide supporting documentation related to the sample invoices on a timely basis, if at all (see Appendix D for examples). They also did not allow us timely, unrestricted access to the Contractor's cost allocation system to test allocation methodologies. In addition, during the testing we were able to perform, we noted several problems (see **Summary of Findings** below). As a result, we were not able to obtain reasonable assurance that the Contractor's indirect cost allocations to Medicare, as well as some of the direct costs charged to Medicare for FY 1998, were allowable.

Because we were unable to obtain reasonable assurance regarding FY 1998 costs, we determined that extensive testing in the other years would be necessary. Given the lack of cooperation on the part of Contractor officials regarding our FY 1998 tests, we decided the level of testing necessary for the other years could not be completed in a reasonable period of time. Consequently, we have set aside for CMS resolution (a) most indirect costs claimed and some direct costs in FY 1998 and (b) all indirect costs and some direct costs claimed by the Contractor for the other 3 FYs. Our audit covered $371,911,540 in costs claimed by the Contractor with the exception of $13,246,020 in pension and related costs[5] that we excluded from our review and, therefore,

[5] Related costs" include post-retirement costs other than pensions (i.e., cost covered by Financial Accounting Standards Board Statement 106) as well as costs incurred under the Contractor's supplemental retirement program, also referred to as the Long-Term Investment Program.

render *no opinion* on these costs for our audit period. Separate audits of the Contractor's compliance with pension plan requirements are conducted by OIG's Region VII office.

We conducted our review at the Contractor's offices in Jacksonville, Florida with on-site fieldwork beginning on October 14, 1999 and ending May 12, 2000. At that time, the Contractor had not provided a significant amount of information in response to our documentation requests, so we agreed to accept additional documentation until May 26, 2000. The Contractor, however, continued to supply documentation until July 19, 2000. Since that time, we have considered all documentation the Contractor provided. The Contractor's final comments were submitted in August 2001 and since that time we have been working with the Contractor's staff in an attempt to resolve the findings.

Findings and Recommendations

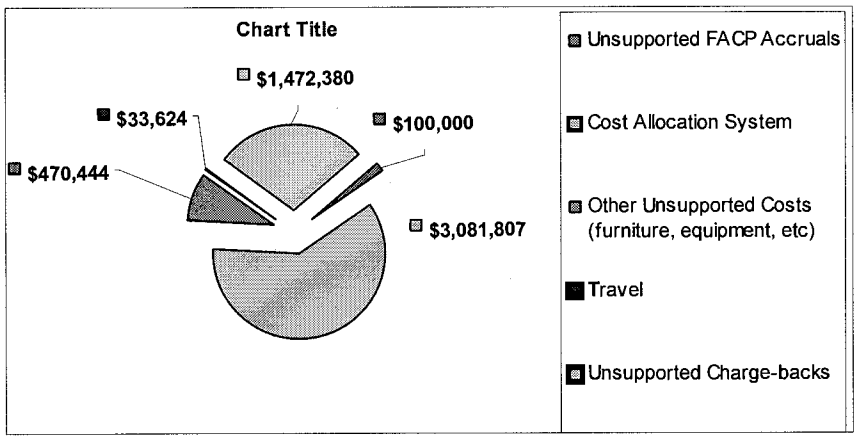
We have included the Contractor's response to our draft report findings in Appendix F. Please refer to this Appendix for a full response to each audit finding.

Of the $371,911,540 claimed by the Contractor, we: (a) identified $5,158,255 of unallowable charges to the Medicare program, (b) set aside $104,836,580 for CMS resolution, and (c) did not audit $13,246,020 in pension related costs.

The $5,158,255 (Appendix B, page 2 of 2) in recommended disallowed costs is composed of the following:

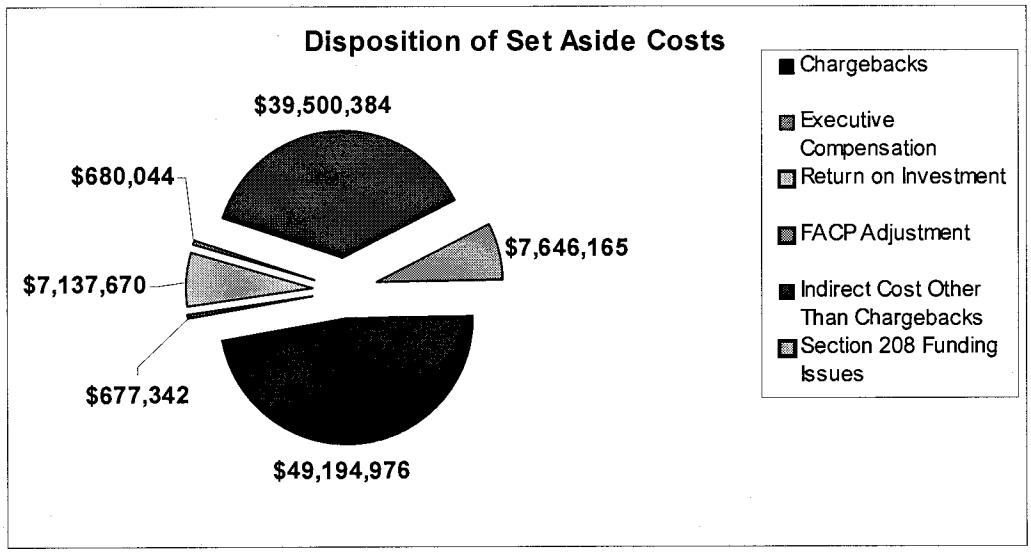
- $100,000 in adjusted cost that the Contractor agrees was non-reimbursable.
- $1,472,380 for unsupported costs relating to chargebacks in cost centers (cc) 381, 810, 881, and 955.
- $470,444 in other costs that the Contractor failed to provide support.
- $406,637* in unsupported discrepancies between accounting records and the FACP.
- $89,310* in unallowable lobbying costs.
- $360,739* for expenses that did not benefit the Medicare programs.
- $2,021,798* for indirect cost allocations contrary to the Federal Acquisition Regulation (FAR).
- $203,323* for improper reversals.
- $33,624 in travel costs in excess of Federal Travel Regulation (FTR) limits.

* These amounts sum to $3,081,807.



Of the $104,836,580 in set aside costs, $95,833,029 were because the Contractor's actions negated our ability to gain reasonable assurance that costs were properly stated and allowable. These costs are as follows:

- $49,194,976 of chargeback costs
- $39,500,384 of indirect costs other than chargebacks
- $7,137,670 of Return on Investment (ROI) costs



The remainder of the costs set aside relates to section 208 issues[6] ($7,646,165), executive compensation ($677,342), and an FACP adjustment ($680,044). For a detailed breakdown by FY, see Appendix C.

Inadequate Documentation Results in $2 Million Unsupported and $5.5 Million Set Aside

Contractor officials did not provide adequate support for $2,042,824 in costs claimed for FY 1998. These unsupported costs included:

- $470,444 in other costs
- $1,472,380 in costs related to chargebacks
- $100,000 in FACP accruals

As a result, the Contractor overstated its claim for FY 1998 administrative costs by $2,042,824. Additionally, the Contractor claimed $5,588,600 in FACP accruals that appear questionable, however, we have set these costs aside for CMS resolution.

Contractor officials did not provide any support for $470,444 in other Med B costs representing:

- Furniture and non-electronic data processing (EDP) equipment of $40,542 and payroll adjustments of $7,686 for a total direct cost of $48,228.
- Furniture and equipment of $89,832, materials and supplies of $330,643, and miscellaneous costs of $1,741 for a total indirect cost of $422,216.

Contractor officials also did not provide support for $1,472,380 in Med B chargebacks representing: $158,829 in facilities and occupancy costs, $1,205,959 in EDP equipment costs, and $107,592 telephone costs.

The FAR 31.201-2(d) states that "A contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart and agency supplements. The contracting officer may disallow all or part of a claimed cost which is inadequately supported." The Medicare contract with the Contractor also states in Article II, section H, that "The [Contractor] shall...maintain such records and afford such access thereto as the Secretary finds necessary to assure the correctness and verification of the information necessary for the administration of this contract."

[6]Section 208 issues refers to the HHS and Related Agencies Appropriation Act of 1993 that states that "Funds provided in this Act...may be used for one-year contracts which are to be performed in two fiscal years...." Section 208 as used here refers to issues regarding the proper period for claiming a cost.

Additionally, during the period of our on-site audit work, the Contractor did not provide any support for $5,688,600 representing FY 1998 accruals ($2,579,856 for Med A and $3,108,744 for Med B). These accruals related to differences between the first FACP filed and the FACP that we audited (the 10th FACP filed for FY 1998 by the Contractor).

After our draft report was issued, which considered these costs to be unallowable, the Contractor provided some supporting documentation for the $5,688,600 in accruals, agreed with $130,000 of our recommended disallowance, and disagreed with the remainder. The Contractor stated that they made a $30,000 adjustment to a subsequent FACP to partially offset the $130,000 concurrence. However, the adjustment was made outside of our audit period and we were not provided any evidence that the adjustment was made. In lieu of adequate documentation, we are setting aside the $30,000. Of the $5,688,600 initially reported, we consider $100,000 to be unallowable, representing the CMS concurrence we can account for, and we are setting aside the balance of $5,588,600 for CMS's adjudication.

The Contractor provided sufficient information for us to determine the nature of the $5,588,600 in accruals to which they disagreed with our position. Based on our review of their supporting documentation, the costs appear to have been incurred and related to Medicare contracts. However, while our need for supporting documentation has been satisfied, the documentation presented a new concern.

We are concerned about the manner in which the Contractor accounted for these funds, apparently using obligated accounting. According to the Cost Accounting Standards Board, the obligated accounting basis can be used by Government entities, but not by their contractors. For the most part, the Contractor uses the accrual basis of accounting. However, in this case the Contractor used the obligated basis of accounting for the cited costs by incurring the costs in one accounting period (FY 1999) and reporting the costs in a prior accounting period (FY 1998). According to the Cost Accounting Standards Board, they are not permitted to use the obligated method of accounting. Based on this, we cannot conclude that these costs are allowable as claimed. It appears to us the Contractor used a questionable accounting practice in order to claim the $5,588,600 in FY 1998.

The FAR 31.201-1 gives the general rule regarding accounting methods. It states that "In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used...."

The FAR 9903.302.1, "Cost Accounting Practice," gives two examples of accounting methods. It states that "Assignment of cost to cost accounting periods,...refers to a method or technique used in determining the amount of cost to be assigned to individual cost accounting periods. Examples of cost accounting practices which involve the assignment of cost to cost accounting

periods are requirements for the use of specified accrual basis or cash basis accounting for a cost element."

We are concerned with the Contractor's accounting and reporting practice regarding these costs. We consider the Contractor's methods to be questionable. However, we were informed that the Contractor was operating under instructions from CMS. Consequently, we are unable to express an opinion on the allowability of $5,688,600 of the amount originally considered unallowable, and leave this issue for CMS resolution.

Recommendation

We recommend that the Contractor reduce its FY 1998 claim by $2,042,824 ($470,444 + $1,472,380 + $100,000) for costs that were not adequately supported. We also recommend that the Contractor improve its internal controls through the design and implementation of procedures for the reconciliation of costs allocated to Medicare from Contractor accounting records to detect and prevent improper allocations.

Additionally, we are unable to express an opinion on the allowability of $5,588,600 ($5,688,600 - $100,000), representing FACP accruals. We are setting these costs aside for CMS resolution. This total is net of $100,000 considered unallowable, which is included in the $2,042,824 above.

Auditee Comments

(For continuity with the complete text of auditee comments, the amounts in bold shown in the auditee comments throughout the report are based on the draft findings and may not agree with the amounts in the final report. The final report amounts are addressed and detailed in the OIG Response sections immediately following each of the Auditee Comment sections.)

Generally, the Contractor disagreed with our findings that these costs were unsupported. They provided specific comments for most of the amounts, and in some instances provided documentation or statements to explain the costs. Following are summaries of Contractor comments for each cost item questioned (for complete Contractor response refer to Appendix F to this report).

(Comments 1.A through 1.E address the $470,444 of other Med B costs.)
1.A. - $40,542 in Furniture and Non-EDP Equipment. The Contractor acknowledged that all supporting documentation was not available to the auditors, but disagreed that the costs cannot be documented. They provided substantial detail as to how their system computes depreciation expense. They created a spreadsheet from their General Ledger Transaction Summary and offered to walk the audit team through the system and records. Their response recognized their

need to strengthen their document retention procedures in order to support actual detail cost claimed.

1.B. - $3,843 in Payroll "Y" Adjustments. The Contractor stated that $3,194.01 of this total represented voided checks, and provided documentation. They also noted that the $725.44 is the result of manual "Y" adjustments.

1.C. - $89,832 in Furniture and Equipment Costs. The Contractor acknowledged that all supporting documentation was not available to the auditors, but disagreed that the costs cannot be documented. They provided substantial detail as to how their system computes depreciation expense and created a spreadsheet from their General Ledger Transaction Summary, offering to walk the audit team through the system and records. Their response recognized their need to strengthen their document retention procedures.

1.D. - $341,174 in Material & Supply Costs. The Contractor indicated that these costs are charges from their Corporate Print Shop and Copy Center and stated that documentation was included.

1.E. – $17,051 of Miscellaneous Costs. The Contractor provided invoices in the amount of $16,014.20 (94 percent of the total) to support the questioned costs.

1.F. - $1,472,380 of Chargeback Costs. The Contractor disagreed with our disallowance of these costs. Their position is that ample support was provided during the audit for the Med B chargebacks totaling $1.4 million. They have included system reports and entries as documentation for these costs. Finally, they provided a detailed explanation of their chargeback system for allocating costs.

1.G. - $5,688,600 FACP Accruals. This amount represents $2,579,856 in Med A costs and $3,108,744 in Med B costs. The Contractor agreed that $130,000 should be adjusted. The Contractor stated that they made a $30,000 accrual adjustment on a subsequent FACP to partially offset the $130,000.

The Contractor disagreed with $5,558,600 of disallowed costs. Addressing the $2,579,856 in Med A costs, the Contractor cited an $83,334 cost reduction and specifically addressed the remaining Med A costs as follows:

- $700,000 related to section 208 funding and was reported consistent with CMS practice; documentation provided.
- $100,200 related to section 208 funding; documentation provided.
- $1,847,520 related to Y2K expenditures incurred in FY 1999 but reported against the FY 1998 NOBA, per CMS instructions; documentation provided.

- $5,563 related to Section 208 funding; documentation provided.
- $9,853 related to the ORT initiative; documentation provided.

(Auditor noted a $54 rounding difference in Contractor's amounts.)

The Contractor also cited the criteria for use of section 208 funds and stated that CMS approved several section 208 projects for Medicare in FY 1998. These criteria permit funds to be used for 1-year contracts that are to be performed over the course of 2 FYs.

The Contractor addressed three components comprising the Med B total of $3,108,744 as follows:

- $100,000 related to cc372. The Contractor agreed with the report and will reduce its FY 1998 FACP by $100,000.
- $1,152,478 for section 208 funding reported consistent with CMS instructions; documentation provided.
- $1,856,266 related to Y2K expenditures incurred in FY 1999 but reported against the FY 1998 FACP #10, per CMS instructions; documentation provided.

OIG Response

1.A. - $40,542 in Furniture and Non-EDP Equipment. To verify that this expense was properly calculated, the auditor must have the requested information such as the method of depreciation calculation that includes data such as asset basis, useful lives, method of depreciation, etc. The Contractor's response still does not address our specific audit request. The requested information is necessary in order to validate the appropriateness of costs selected for audit. Based on the information received, no change is warranted.

1.B. - $3,843 in Payroll "Y" Adjustments (amount questioned is now $7,686). Based on our review of the documentation, it appears that the Contractor is correct in stating the costs relate to voided paychecks and negative adjustments to pay for time differences. However, the problem with this documentation is that this "Y" adjustment of $3,843 was a positive adjustment to the FACP (additional amount claimed). As a result, the Contractor added these costs back into the reimbursable costs. As a voided check, the adjustment to the FACP should have been negative, thus the FACP is overstated by $7,686. Our draft adjustment, therefore, has been doubled to $7,686 to eliminate the incorrect claim for $3,843 in positive adjustments as well as to reduce the FACP claims by the amount of the voided checks.

1.C. - $89,832 in Furniture and Equipment Costs. The $89,832 of non-divisional[7] costs is composed of depreciation and maintenance expense. To adequately support the costs claimed for

[7]The Contractor refers to their direct costs as divisional costs and their indirect costs as non-divisional.

depreciation, the Contractor should have but failed to provide documentation of the asset basis, assigned useful life, and depreciation methodology (i.e., straight line, accelerated, sum of the years digits, etc.), and the invoices for maintenance.

In their response, the Contractor recognized the need to improve their document retention procedures. Without adequate documentation, we do not have reasonable assurance that depreciation was properly and/or reasonably computed or that maintenance costs were incurred. We reviewed all of the documentation provided to us; however, their response remains inadequate, therefore, no change to our original adjustment is warranted.

1.D. - $341,174 in Material & Supply Costs (amount remaining questioned is $330,643). We reviewed the invoices and other documents offered as support relating to the $341,174 in material and supply costs previously questioned for lack of documentation. Most of these costs were non-divisional or allocated costs to Medicare. Within the documentation provided, we found only $10,531 to be adequately supported and allowable.

Some of the documents provided by the Contractor indicated that the costs were not allocable to Medicare. For example, records provided for a $13,040 amount indicated that the cost was for private business operations member billings that did not relate to Medicare. A $27,500 item was for the State of Florida identification cards that relate specifically to private side business. The documents provided also indicate a $22,835 cost was related to the Contractor's private side health maintenance organization listings. The Contractor's response further demonstrated how unallowable costs are allocated to Medicare.

The remaining documentation consisted primarily of journal entries and chargeback sheets that supported the Contractor's assignment of costs but did not support the specific costs or the benefit that these costs would have to the Medicare contracts. Therefore, the documentation for $330,643 is not adequate and these costs are still considered unallowable.

1.E. – $17,051 of Miscellaneous Costs (amount still questioned is $1,740). We reviewed the documentation supplied and noted that the costs appear reasonable and allowable, except for $731 in lobbying costs (computed as $4,568.89 total invoice cost times 16 percent [the amount noted on the invoice as being attributable to lobbying]); and $1,009 for an invoice that the Contractor could not locate. These two amounts should remain as disallowed ($1,740) and the remainder of the adjustment will be reversed.

1.F. - $1,472,380 of Chargeback Costs. First, we do not take issue with the concept of chargebacks. In fact, we have attempted to gain information to document how these chargebacks are computed. The Contractor's computer system provides summary reports, but this is as detailed documentation as we have been able to get. The computer reports include several assumptions we have attempted to verify, such as how the Contractor has arrived at the rate, how

they determined the accumulation of the allocation basis, and how they arrived at the percent of usage attributable to Medicare. The Contractor's responses do not address these issues and are very general. For us to conclude that the costs are allowable, supporting documentation must include detailed support for each transaction. Consequently, no change in our position is warranted.

1.G- $5,688,600 FACP Accruals (amount set aside is $5,588,600; amount disallowed is $100,000). In a meeting held at the CMS regional office in Atlanta, Georgia, CMS officials stated that they did instruct the Contractor to report these costs in the manner followed by the Contractor. We do not agree with this accounting for the use of funds, but leave it to CMS's discretion to resolve $5,588,600 of this amount. The remaining $100,000 is unallowable, as concurred by the Contractor.

The Contractor's Data Did Not Support Cost Discrepancies of $407 Thousand

The Contractor did not support discrepancies of $406,637 between total costs allocated to Medicare and its internal accounting records, resulting in a net overstatement by that amount.

During our tests to reconcile the total costs allocated to Medicare, we determined that the Contractor's Medicare personnel use a data set of costs (referred to as HCFA [CMS] "cube") to prepare the FACP. However, this data set includes only costs allocated to Medicare. It does not include total costs incurred prior to allocation (otherwise known as unallocated costs). As a result, we could not utilize the HCFA [CMS] cube to analyze the cost allocations to Medicare.

To overcome this limitation, we identified a second data set reportedly containing all costs (referred to as the "Alloc cube" or "Cumulative Alloc cube" by Contractor personnel). To ensure that the HCFA [CMS] cube and the Alloc cube were consistent, we compared the amounts allocated to Medicare. We found discrepancies totaling about $400,000 for FY 1998 with the HCFA [CMS] data set showing greater costs than the Alloc data set.

To explain these discrepancies, Contractor officials initially advised us that the Alloc cube was the most accurate because it reflected corrections of errors and allocations based on the most recent cost data available. When we then proposed reducing claimed costs to the amounts reflected in the Alloc data set, they recanted this explanation. They then said that the Alloc data set was a developmental data set, not production, so it should not be used for financial reporting purposes.

During these discussions, Contractor staff then suggested we use a third data set (known as the "Detail cube") to validate costs in the HCFA [CMS] data set. We immediately agreed with this suggestion since this test would take less than 1 hour. Contractor officials overruled this suggestion; however, and we were denied access to the third data set.

As a result, we were not able to reconcile the costs reflected in the CMS data set to those reflected in the Alloc data set. Thus, we consider the $406,637 to be unallowable.

Recommendation

We recommend the Contractor reduce its claim for reimbursement for FY 1998 by $406,637 as follows:

- Increase its claim for additional Medicare disbursement for $115,449 for additional Med A costs.
- Decrease its claim by $522,086 in FY 1998 for Med B costs.

Auditee Comments

The Contractor's position is that there was no overstatement of FACP costs and that no reduction of their claim for reimbursement is necessary. They provided documentation to make their point, stating that had the auditors used the correct extract, containing total costs prior to allocation, no discrepancy would have existed. In disagreeing with the report, the Contractor comments mainly addressed the "Alloc" or "Cumulative Alloc" cube, stating that it should not have been used for any official purpose. They contend that since the auditors erroneously relied on the "Cumulative Alloc" cube, they arrived at an invalid finding.

The Contractor notes that it uses a 1-month accounting period. They state that they used the "Cumulative Alloc" cube to demonstrate that the use of a monthly accounting period does not yield materially different results in cost allocations than the use of an annual accounting period. This comment is in relation to a net difference of $406,637.

Additionally, they noted that they did not recommend the use of the "Cumulative Alloc" cube, thus they had nothing to recant. Nor did they "overrule" the auditor's suggestion of using a third data set – the "Detail" cube. If asked, the Contractor would have indicated which was the proper data set to serve as a comparison to the costs in the Medicare data set.

OIG Response

The documentation and explanations offered by the Contractor do not justify the $406,637. In addition, the assertion is false that we did not ask for access to another set of data to verify the validity of the annual data. Auditors repeatedly requested access for applicable data and the denial of access for this particular item was part of a pattern of denial of access described in more detail in Appendix D.

This issue can be reduced to a disagreement over materiality. The Contractor claims that a monthly reporting system, unadjusted to account for monthly volatility, is not materially different than an annual system. We do not agree that the difference is immaterial and continue to recommend that the $406,637 difference between monthly and annual reporting methods be disallowed.

We relied on the cumulative data as opposed to monthly data because annual data eliminates the volatility and the imprecision associated with monthly data. For example, using a monthly allocation, it is possible to generate a higher total allocation to Medicare by choosing to incur or accrue a significant amount of shared costs in a month when Medicare costs form a greater portion of total costs. This kind of distortion and management of results is not possible using a cumulative, annual cost base.

Furthermore, the Contractor incorrectly attributes a monthly final allocation requirement to the regulations; no such requirement exists. In fact, the FACP that is the subject of this audit, is an annual report. It is true that the Contractor produces monthly reports; however, these are acknowledged to be *interim* reports (their title is Interim Expense Report or IER). The aggregate of monthly interim reports are not equal to the annual FACP. This is evidenced by the many adjustments made to the interim reports to arrive at the FACP. If the monthly reports were final reports, as opposed to interim reports, there would be no need for such adjustments. In fact, the annual adjustments are so numerous that the Contractor has filed multiple FACPs for FY 1998. Our audit used FACP number 10 as the subject of the audit (in order to avoid trying to audit a moving target), but the Contractor has filed several more amendments to the original FY 1998 FACP since number 10.

The Contractor Claimed Unallowable Lobbying Costs Totaling $89 Thousand

The Contractor claimed $89,310 in lobbying costs that are not allowable per Federal regulations, thus overstating its claim for reimbursement by that amount.

We identified lobbying costs in two cost centers: (1) cc82 ("Health Care Reform") and (2) cc240 ("Public Policy") that allocated to Medicare. The Contractor's documentation gave the following descriptions for these cost centers:

- cc82 - "to advocate bcbsf's (*sic*) public policy positions to state and federal legislators...."
- cc240 - "to lead bcbsf (*sic*) in developing public policy positions that support a private health system...should be set up as a default "95" cost center."

Lobbying and similar costs are expressly unallowable per FAR 31.205-22(a). The Contractor's note in the description for cc240 regarding use of code "95" recognizes that fact. The "95"

descriptor to a cc is used by the Contractor to allocate to a non-Medicare cost recipient, indicating the costs are not allocable to Medicare.

The amounts claimed are reflected in the Contractor's allocation system in the amounts of $2,130 (cc82) and $87,945 (cc240), both shown as being allocated to Medicare Part B. This allocation system is the one used by the Contractor to prepare its FACP.

The system report that reflected these amounts had the title "PPlay8 of cumallc3 (Reporter)" and included columns for total unallocated cc costs as well as amounts allocated to Medicare Part A and Medicare Part B. The reported amounts were for Calendar Year (CY) 1997. The system produces amounts by CY rather than FY; therefore, we requested reports reflecting the totals for FYs 1997 and 1998 (total costs and allocations to Medicare Parts A and B), but we did not receive them. However, the Contractor provided evidence that these costs were only allocated to Medicare in FY 1997. They made an adjustment in FY 1998 so the costs would not be allocated to Medicare.

For cc240, to determine the FY 1997 amounts allocated to Medicare, we obtained system reports for the months of October, November, and December 1997 (applicable to FY 1998). These reports reflected a total of $754 allocated to Medicare Part B. Since these months applied to FY 1998, we reduced the $87,945 amount by the $754 to arrive at an adjusted amount of $87,191 covering the second, third, and fourth quarters of FY 1997. These same system reports showed $11 to cc82 in FY 1998, thus this cc total allocation to Medicare was reduced from $2,130 to $2,119. The total Medicare allocation for these two cost centers in FY 1997 was $89,310 ($87,191 + $2,119).

The $89,310 represents only 9 months of the FY, so the total may be understated. As stated earlier, we requested but did not receive reports for FY 1997, so we were unable to determine the amounts allocated in October, November, and December 1996 (the first quarter of FY 1997).

Recommendation

We recommend that the Contractor reduce its claim by $89,310 for these unallowable costs. To prevent future unallowable allocations, the Contractor should allocate all lobbying costs using a description code that prevents allocation to Medicare (the "95" code).

Auditee Comments

The Contractor acknowledged that lobbying costs were unallowable and that such costs were included in cc082 and cc240. They added that their system has a means of accumulating and segregating such costs, and that the lobbying costs were not included in the FY 1998 FACP. They provided documents to demonstrate that the costs were not allocated to Medicare.

OIG Response

Our recommended disallowance was based on the Contractor's own internal records which indicate the lobbying costs in the two cost centers were allocated to Medicare. The Contractor provided no evidence that any adjustments were made to the FACP to exclude the costs from Medicare reimbursement. The Contractor has a code which when properly applied, identifies unallowable lobbying costs in the system. However, these costs were not controlled by this code, and their own records state the costs were allocated to Medicare. Based on our review of data supplied while on-site, as well as data included with the draft report response, no change in our recommendation is warranted.

The Contractor Claimed $361 Thousand of Costs That Had No Benefit to the Medicare Program

Contrary to Federal regulations, the Contractor claimed costs of $360,739 for expenses that did not benefit the Medicare program. These costs were for (1) a corporate re-engineering project ($118,360) and (2) general research ($242,379).

Corporate Re-Engineering

The Contractor appears to have inadvertently claimed costs of $118,360 related to a corporate re-engineering project, known as Virtual Office (VO), that does not benefit the Medicare program. As a result, the Contractor overstated its claim for reimbursement by $118,360.

The FAR 31.201-4 states "(a) cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship...."

The Contractor routinely allocated VO costs through its cost allocation system to all lines of business. Because Contractor officials were apparently aware VO did not benefit Medicare, they would then subsequently remove any VO costs allocated to Medicare through a reversing entry. However, we identified one cc where this was not done (cc14 "HR Business Transformations"). The description in the Contractor's documentation for this cc reads "provides human resource support for the business transformation initiative (i.e., virtual office)." The Contractor allocated costs in cc14 to Medicare, but did not reverse all of the costs. This resulted in an overstatement of Medicare costs of $118,360. As in an earlier finding, this total only represents 9 months of the FY and is likely understated.

The Contractor provided reports that reflected FY 1998 totals and CY 1997 totals. They did not produce FY 1997 totals, so we quantified the costs to the extent possible with available documentation. The Contractor reports for FY 1998 indicated that $18,330 was allocated to

Medicare Part B and $4,984 was allocated to Medicare Part A, for a FY total of $23,314. For FY 1997, we used a report entitled, "PPlay8 of cumallc3 (Reporter)." The CY 1997 report reflects $18,910 allocated to Medicare Part A and $76,136 allocated to Medicare Part B for a total of $95,046 during the first 9 months of CY 1997 (the last 9 months of FY 1997). The total allocations from all reports are $118,360.

Recommendation

We recommend that the Contractor reduce its claim by $118,360 to remove these unallowable costs. To prevent future inappropriate allocations of these types of costs to Medicare, we also recommend that the Contractor allocate these costs using a descriptor code that prevents allocation to Medicare (the "95" code).

Auditee Comments

The Contractor agreed in part with this finding but based on their data, stated that the FACP should only be reduced by $14,085. They note that the cc in question was not initially established to work on the VO project. The cc was established to provide management and leadership of corporate human resource strategy and to work on special projects. In February 1998, the cc began supporting the VO project exclusively and should not have been allocated to Medicare. Thus, from February forward, the cost allocations were incorrect, totaling $14,085. The Contractor's position is that there is no basis to conclude that cc allocations prior to February 1998 were unallowable.

OIG Response

The Contractor offered no evidence that the cc performed a function benefiting Medicare or that the cc was not engaged in supporting a re-engineering function prior to February 1998. They offer only an undocumented assertion that the cc changed function in February 1998. In fact, according to the documentation supplied, the Contractor was previously engaged in corporate re-engineering projects (a 1996 management letter states in part: "Since 1990, the Contractor has invested approximately...in various reengineering projects.") Available evidence indicates a pattern of non-Medicare activity prior to February 1998, and the Contractor's internal reports indicate that lobbying costs were allocated to Medicare. Therefore, we consider the amount allocated to Medicare to be unallowable.

General Research

The Contractor claimed $242,379 in research costs that were unallowable because they did not benefit the Medicare program. As a result, the Contractor overstated its claim for reimbursement by that amount.

The Contractor accumulated these costs in two cost centers: (1) cc270 Business Research and (2) cc75 Corporate Research. The descriptions of these two cost centers are as follows:

- cc270 – "...economic, socio-demographic, technological, and other external environment trends and issues...."
- cc75 – "...collect...and announce information on health care...."

The FAR 31.201-4 requires that a cost be allocated "on the basis of relative benefits received or other equitable relationship." The non-directed or basic research engaged in by the Contractor in these two cost centers did not, however, provide any tangible or incidental benefit to Medicare. In addition, the Contractor's function related to Medicare is very specific in nature - processing Medicare Part A and Part B claims and related services. The Contractor has not provided documentation to support the necessity of research in performing their contractual obligations to CMS.

Recommendation

Because these research costs do not appear to have any tangible or incidental benefit to Medicare and are therefore unallowable, we recommend that the Contractor reduce its claim by $242,379 for these costs. To prevent future inappropriate allocations of these types of costs to Medicare, we also recommend that the Contractor allocate these costs using a descriptor code that prevents allocation to Medicare (the "95" code).

Auditee Comments

The Contractor states that the cost centers in question provide services that benefit the entire company, including the Medicare unit. The cost centers provide information for management decisions, strategic planning, and utilizing corporate resources. Their position is that the costs are allocable to Medicare as "economic planning costs" pursuant to FAR 31.205-12.

OIG Response

Our review of the cost centers' functions and our review of the Contractor's comments have failed to show any benefit to Medicare from these research cost centers. Thus, we consider the costs as unallowable. Throughout our review, the Contractor failed to establish the relationship of the cost benefit relative to the costs allocated to Medicare. The Contractor's position is that because a cost is allowable in principle, it is therefore necessarily allocable to Medicare. This interpretation, however, is rejected by the FAR which states that "The factors to be considered in determining whether a cost is allowable include...Allocability...[§31.201-2]" and that "A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative

benefits received [§31.201-4]." It is not enough that the Contractor incurs a cost; it must also demonstrate a benefit to Medicare. Based on our review of data and understanding of regulations, no change in this finding is warranted.

The Contractor Claimed $2 Million in Indirect Cost Allocations Contrary to the FAR

The Contractor's cost allocation system allocated indirect costs contrary to Federal regulations resulting in an overstatement of $2,021,798. These costs related to:

1. Support centers ($1,326,477)
2. Internal audit ($89,339)
3. Miscellaneous finance ($601,605)
4. Miscellaneous costs ($4,377)

1 - Support Center Costs

The Contractor claimed $1,326,477 in support center costs that were not allowable because of excess allocations. As a result, the Contractor's claim for reimbursement was overstated by that amount.

We identified several cost centers that allocated an unusually high percentage of costs to Medicare in 1997 and/or in 1998. These cost centers were:

- cc041 Human Resource - Integrators (1998 only)
- cc289 Electronic Data Interchange (EDI) Infrastructure
- cc615 Internal Audit
- cc833 IT Marketing
- cc835 Network Equipment (1997 only)
- cc858 [Systems] Development Center (1997 only)
- cc898 Electronic Commerce Systems (1998 only)

These cost centers were similar because: (1) they generally benefited all lines of the Contractor's business and (2) the amount of costs the Contractor allocated to Medicare was unusually high (nearly double the General and Administrative (G&A) allocation rate of 14 percent). We determined that these unusually high allocation rates were caused by the design of the Contractor's allocation system.

For the cost centers mentioned above, the design of the system excluded approximately half of the costs allocable to the Contractor's non-Medicare lines of business. This exclusion understated the non-Medicare allocation bases, thus, understating the non-Medicare allocation rate and overstating the Medicare allocation rate. Consequently, Medicare received excess

allocations of support center costs. This only occurred with the cost centers designated as support cost centers.

This design is contrary to FAR 31.203(c) that states in part "All items properly included in an indirect cost base should bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs."

The Contractor designated these cost centers as "Support" cost centers (allocation basis type ranging from 200 to 799) during the years where we noticed excessive allocations to Medicare. The Contractor was not consistent with their designation during the 2 years we reviewed. The designation fluctuated between "Support" with its higher allocation rate and "G&A" which had a much lower allocation rate of 14 percent. For example, cc041 and cc898 were designated as "G&A" cost centers in 1997 and as "Support" in FY 1998. Conversely, cc835 and cc858 were designated as "Support" cost centers in FY 1997 and as "G&A" in FY 1998.

Two potential approaches were available to respond to this finding. First, the Contractor could reconstruct the allocation of these costs based upon including all costs in the non-Medicare allocation base. This approach was not practical. Second, the cost centers could be fairly treated as "G&A" cost centers. We chose the second alternative.

To compute the amount of the proposed disallowance, we used the following Contractor supplied records: For FY 1998, we used a report entitled, "PPlay13 of cmlallc1 (Reporter)" and "PPlay10," "PPlay11," and "PPlay12" "of Allocrst (Reporter)." The first report contains information for the first 3 quarters of CY 1998. The last three reports contained information for October, November, and December 1997. Adding the reports together gave us FY 1998 information.

For FY 1997, we used a report entitled, "PPlay8 of cumallc3 (Reporter)" which contains information for CY 1997, and the same 3-monthly reports cited above (for October, November, and December 1997). Subtracting out the total of the 3-monthly reports (representing the 4th quarter of CY 1997) from the CY 1997 report gave us all but the 1st quarter of FY 1997. Though we requested information for the 1st quarter of FY 1997, we did not receive it. As a result, the information used to calculate the proposed adjustment is based on only 3 out of the 4 quarters for FY 1997, and the resulting proposed adjustment is thus understated.

We identified $637,656 for FY 1998 ($143,349 for Med A and $494,307 for Med B), and $688,821 for FY 1997 ($136,927 for Med A and $551,894 for Med B) that we considered to be excess allocations.

In addition, the Contractor's "G&A" allocation rate is based on the aggregate of costs previously allocated under other bases including "Support." Thus, the overstatement of allocations to

Medicare as a result of the error noted above caused a corollary overstatement of costs allocated under the "G&A" basis. Our recommended adjustment takes this double impact into consideration.

Recommendation

We recommend that the Contractor reduce its claim by $1,326,477, representing $637,656 for FY 1998 and $688,821 for FY 1997. This represents the amount needed to reduce the identified cost centers to the "G&A" rate used for other cost centers. We also recommend that the Contractor change its internal control structure to modify its cost allocation base to prospectively include all non-Medicare costs so proper allocations of "Support" cost centers will occur.

Auditee Comments

The Contractor provided general comments about the overall finding that includes four sections (support center costs, internal audit, miscellaneous finance, and miscellaneous costs) and also provided specific comments addressing each section. First, the general overall comments.

The Contractor acknowledged that some cost centers should have been allocated differently. However, they added that the allocations were not the result of flaws in the design of their Cost Allocation System, rather they were based on incomplete information about the cost centers being input into the system when it was redesigned in 1997. They observed that there was need for continuous improvement in their Cost Allocation System. In that regard, they have undertaken several reviews to improve the allocation process. They acknowledge that they have underestimated the elusiveness of the concept of "benefit" in cost accounting, and therefore agree with several of the draft audit report findings.

Following are specific comments about the support center costs we questioned. The remaining Contractor comments addressing the other three sections (internal audit, miscellaneous finance, miscellaneous costs) of this finding follow each section where that topic is addressed within this report.

More specifically, the Contractor's position is that their system for allocation of support center costs does not violate the FAR. They mentioned specific reviews of their system by others and noted that there were no significant findings with respect to their allocation philosophies or practices. They individually addressed six cost centers specifically identified regarding support center costs:

- cc041 - Their position is that this cc was allocated properly. From October 1997 through January 1998, it was allocated administratively over all lines of business. Since February 1998, 50 percent of the cc was allocated as a "support" cc to all lines of business

and the remaining 50 percent was excluded from Medicare allocation. Overall, the percentage of allocation remained about 14 percent, closely approximating the "G&A" rate.

- cc289 - Their position is that they have consistently treated this as a "support" cc and believe this cc should have been charged at a higher rate. This cc is allocated based on EDI claims volumes, and in FY 1998 there was an error in the percentage of claims assigned to Medicare that was corrected in FY 1999. The error resulted in Medicare being undercharged by $622,830.
- cc898 - Their position is that the allocation basis for this cc should be changed, resulting in additional costs being allocated to Medicare. During the 1st quarter of FY 1998, this cc was allocated administratively at 12.7 percent. The allocation method was changed to support from January 1998 through September 1998 at a rate of 25.3 percent. Upon further review, the method should be based on a ratio of electronically filed claims, resulting in 84 percent of these costs being allocated to Medicare. They will amend the FACP accordingly.
- cc835 - Their position is that this cc was allocated properly. From October 1997 through February 1998, this cc benefited Medicare and was appropriately allocated as "Support." Following a reorganization in March, the cc was properly allocated as a resource cc, which means the costs were allocated administratively.
- cc833 - They agreed that this cc should have been allocated on an administrative basis, but question the amount of our adjustment. They noted that our report data does not mirror that of the Contractor regarding the amount of costs allocated to Medicare.
- cc858 - They agreed that this cc should be allocated administratively, but question the amount of our adjustment. They noted that our report data does not mirror that of the Contractor regarding the amount of costs allocated to Medicare.

OIG Response

Regarding the support costs, the Contractor did not address our observation that the non-Medicare allocation base was understated, thus resulting in excess allocations. This was a significant aspect of the finding.

Regarding cc041, they provided no evidence in their response regarding the claimed reorganization or what detailed methods were used to allocate costs. Instead, the Contractor provided a one-page summary of allocations from cc041 showing monthly allocations ranging from 11 percent to 16.9 percent. The documentation provided us during fieldwork showed that costs in cc041 are allocated using two different allocation methods and rates; one method which is identified as being part of the support allocation error remaining unaddressed by the Contractor and another method that we accepted as reported. The sum of the two methods averages to about 14 percent thus giving the misleading appearance of a "G&A" rate; however, our finding addresses only the systemic flaw involving support allocations to Medicare, not to a separate allocation method in which no costs were allocated to Medicare.

For cc289, they offered no evidence to support the claim that cc289 costs were allocated using EDI claims volume during our audit period. Use of EDI claims volume is a direct relationship to a given customer and would be either an operational or a resource/chargeback allocation method, not the indirect support method reported by the Contractor. Based on documentation supplied to us, cc289 was allocated during our audit period using allocation basis types 301 and 501 which are defined in the Contractor's documentation as "The basis type...used whenever a cost center function supports specific products" (for type 301) and "Cost center/functions which are *allocated using the total operational results* of the MST(s) [*market segments*] they support [italics added]" (for type 501). They included a copy of a brief e-mail recommending using certain transaction volume and tentative percentages as an allocation basis for cc289, and it appears that this note is evidence of a suggested change from the existing support allocation method used for cc289. In any case, the Contractor failed to address the specific finding regarding allocations from support cost centers nor did they supply any evidence for the claim they made for a suggested change in the allocation method.

For cc898, they offered a one-page report apparently showing the results of a higher allocation rate based on reclassifying the allocation method used for cc898 from support to chargeback. They provided no evidence in support of this reclassification or for the numbers reflected in the one-page report.

For cc835, they erroneously claimed that this cc was allocated at an administrative rate. In fact, it states "under the resource allocation method, expenses are, in fact, allocated administratively with an offsetting credit for chargebacks in cc810." While it is true that the costs from resource centers are allocated at an administrative rate, this is only an accounting anomaly of their system offset in terms of total dollars in its entirety by the credit to cc810. In fact, their system allocates the same chargeback cost three times:

- First, as a charge recorded in the recipient cc through the resource allocation layer.
- Second, as a charge to recipient centers through the administrative layer.
- Third, as a credit to recipient centers, also allocated through the administrative layer (cc810).

The third allocation is required because double counting would otherwise result from the second allocation. We do not know why they allocate the second time since it creates a double counting. In addition, the Contractor's elimination of the double counting (through the credit to cc810) causes costs to be misclassified between cost types (salaries and wages, EDP charges, etc.) because the credits in cc810 are not classified the same as the debits in the source chargeback centers (e.g., a wage cost in cc811 is re-classified as an EDP cost in cc810). Since they did not address the support layer finding, they did not adequately address the costs claimed for cc835.

For cc833 and cc858, we attribute the differences in totals to differences in the data sets used by either party in calculating the overpayments (about which controversy still exists). We believe the adjustments reflected in the draft report are correct.

2 - Internal Audit

The Contractor allocated $89,339 in internal audit costs using a methodology contrary to Federal regulations. This resulted in an overstatement of Medicare costs by that amount.

For most of FY 1997 and all of FY 1998, the Contractor allocated internal audit costs using the standard G&A rate of about 14 percent. Contractor officials informed us that for the period prior to this, they allocated costs based on the actual time devoted to the projects. For example, the Contractor tracked the hours spent on each project, then allocated the costs based on time spent to the appropriate line(s) of business (i.e., Medicare projects, non-Medicare projects, and projects with benefits to both Medicare and non-Medicare lines of business).

The FAR 31.001 states in part that, "G&A expense does not include those management expenses whose beneficial or causal relationship to cost objectives can be more directly measured by a base other than a cost input base representing the total activity of a business unit during a cost accounting period."

The Contractor's Internal Audit department tracks the time for each type of project. Project time represents a more direct measure of the benefit to Medicare than the G&A rate used by the Contractor. As a result, the Contractor's methodology of allocating internal audit costs using its standard G&A rate is contrary to the FAR.

To determine the amount of overstatement of internal audit costs claimed by the Contractor, we obtained project time for each project and calculated the amount that would have been allocated to Medicare based on project time. Our review showed that the Contractor overstated the amount that should have been allocated based on project time by $89,339. This amount included $51,314 for FY 1998 ($11,397 for Med A and $39,917 for Med B) and $38,025 for FY 1997 ($9,625 for Med A and $28,400 for Med B).

Recommendation

We recommend that the Contractor reduce its claim by $89,339 because of this overstatement. To prevent future inappropriate allocations, we recommend the Contractor allocate internal audit costs based on project time.

Auditee Comments

The Contractor asserts that these costs should have been allocated based on the administrative expense ratio used for G&A type expenses, and not allocated as a "support" cc. Using the FY 1998 administrative rate of 13.4 percent, they believe a reduction of $116,356 is warranted.

Regarding internal audit, they stated that time records should not be used to determine the benefits received by Medicare because they are not corporate accounting records and they are informal. The causal relationship between the internal audit function and particular lines of business is too removed to justify anything other than the Company's broadest allocation method, the administrative allocation. In addition, they speculate that we would disallow all allocations because the time records exhibit none of the protocols associated with timekeeping for cost accounting.

OIG Response

Regarding internal audit costs, we continue to assert that time records accurately reflect the services rendered for accounting and auditing services in general and for the Internal Audit department in particular. The use of hours to determine benefits received is a standard not only in accounting, but in other service industries as well (e.g., legal and programming). The reasons given for not using existing internal audit time records are, we believe, without merit.

3 - Miscellaneous Finance

The Contractor over allocated $601,605 in miscellaneous finance costs. This resulted in an overstatement of Medicare costs by that amount.

The Contractor accumulated miscellaneous finance costs in cc699 - Miscellaneous Finance. The Contractor classified this as an administrative cc with an allocation basis type of 901 (Administrative). Basis type 901 is designed to allocate at an overall G&A rate (about 14 percent for 1998).

The Contractor allocated costs from this cc normally in FY 1997, but allocated costs for FY 1998 at about 19 percent. The individual accounts within the cc were not allocated at the same percentage (e.g., non-ROI costs allocated at about 25 percent). This variance was especially apparent given that there were 87 accounts at the 14 percent G&A rate and cc699 was the only one allocating in excess of that rate.

We were unable to determine any justification or cause for the excessive allocation in FY 1998. Therefore, we limited the FY 1998 allocation to the G&A rate of 14 percent. The higher

allocation in FY 1998 resulted in a $128,738 overcharge to Med A costs and a $472,867 overcharge to Med B.

Recommendation

We recommend that the Contractor reduce its claim by $601,605 for the unsupported and excessive allocations in FY 1998. To prevent future overstatements, we also recommend that the Contractor design and implement policies and procedures to prevent this over allocation.

Auditee Comments

Regarding miscellaneous finance, the Contractor stated cc699 was comprised of diverse costs that require diverse allocations. They offered as examples: "vacation and holiday accruals, ROI for real estate and equipment, and supplemental executive pension." They also mentioned the reversal of a contingent legal liability. They consider the draft report to offer a simplistic view of cc699. They disagree that the cc should be allocated as an administrative expense and consider the recommendation inappropriate.

OIG Response

Beyond the label "diverse," no support was offered for the contention that any of these costs would allocate at a rate higher than an administrative rate.

Regarding miscellaneous finance, we agree that ROI should not be included in consideration of this cc (since the costs are handled in the report elsewhere). As a result, we have reduced the draft finding by $67,089 to $601,605. Regarding the balance of the costs, they offered no evidence in support of any allocation rate, much less evidence that an administrative rate is inappropriate. The word "diverse" does not constitute evidence. In fact, the reference to executive pension costs argues in favor of an allocation rate less than administrative, since the rate at which executive bonuses were allocated was much less than the administrative rate.

4 - Miscellaneous Costs

The Contractor claimed $4,377 in Med B reimbursement that related only to the Contractor's private business, resulting in a $4,377 overpayment:

- The Contractor claimed $1,366 in costs that related to their commercial health maintenance organization.
- The Contractor claimed $1,036 in costs related to its commercial business segment.
- The Contractor claimed $1,975 in costs relating to "ppc manager subscribers" which is the Contractor's preferred provider care private insurance product.

Recommendation

We recommend that the Contractor reduce its claim by $4,377.

Auditee Comments

The Contractor agreed with this finding.

The Contractor Did Not Properly Reverse $203 Thousand in Accruals

The Contractor did not properly reverse accruals for some indirect costs, resulting in an overstatement of costs claimed by $203,323 ($52,602 for Med A and $150,721 for Med B).

The Contractor's allocation system varies the allocation rates for indirect costs based on the variances in the underlying allocation basis data. These variations occur on a month-to-month basis and can vary by accounts within a given cc. When the Contractor reverses a transaction, either to correct an error or to adjust an estimate to actual, the Contractor does not take into account variances in allocation rates between the time of the original transaction and the time of the reversal or correction. The timing of the reversing transaction can affect the amount actually reversed. As a result, when either the unallocated amounts or the variances in the allocation rates (or both) are significant, a material error occurs in the reversal or correction. Currently, the overall pattern appears adverse to Medicare because Medicare has declined as a percentage of the Contractor's overall business, so the Medicare allocation rates have declined over the past few years. As a result, an accrual would most likely be made at a higher rate than the reversal, so the original accrual is never fully reversed.

We noticed this trait of the system while completing other audit procedures. We identified examples of this condition in two cost centers: cc368 (Management Incentive Program) and cc615 (Internal Audit). In cc368, the condition involved FY 1998 reversals of FY 1997 accruals. The reversals were to adjust FY 1997 estimates to actual cost and were handled at a system level.

In cc615, the condition involved the reversal of an error. In October and November 1997, the Contractor allocated to Medicare various costs related to a corporate re-engineering project and then attempted to reverse the allocations in December 1997. The Contractor attempted to handle this reversal in two different ways: (1) by recording a reversal in the general ledger (i.e., a systemic reversal) and (2) by reporting an FACP adjustment. Neither the systemic reversal nor the manual reversal accounted for the actual amount allocated originally.

To give an example, an accrual for a VO cost totaling about $410,000 (referred to as an unallocated accrual) was made in November 1997 and about 28 percent of this total was

allocated to Medicare (referred to as an allocated accrual), using the allocation rate in effect in November. The entry was reversed in December when the allocation rate to Medicare was approximately 23 percent. Thus, Medicare was only credited for 23 percent of the total $410,000, not the entire 28 percent charged earlier. This amounted to an overcharge to Medicare of about $21,000.

In total, we identified $203,323 in overcharges to Medicare through this system practice in only two cost centers. There may be other examples as we only encountered these transactions while doing other work.

Recommendation

We recommend that the Contractor reduce its claim for FY 1998 reimbursement by $203,323 in total costs ($52,602 in FY 1998 Med A costs and $150,721 in FY 1998 Med B costs). We also recommend that the Contractor modify the current methodology to consider differences in allocation rate between the time of the accrual and reversal.

Auditee Comments

The Contractor disagreed with our finding. Since they use a monthly accounting period, allocation rates can vary from month-to-month. Corrections are made according to the basis data at the time of the correction; i.e., allowances are not made for the variances in allocation rates between the time of the original transaction and the time of the reversal or correction. They do not consider the use of a monthly cost accounting period to be materially distortive. Because such an accounting period is applied consistently, is the norm in the industry, and is compliant with FAR, no change in methodology is warranted. They also state that the accruals were fully reversed.

OIG Response

The Contractor's first assertion incorrectly implies that reversal of an unallocated accrual is equivalent to reversing an allocated accrual. Only allocated accruals are relevant, and the sole reason the issue was raised was their failure to reverse *allocated* accruals in their entirety. They presented no evidence to refute that condition, instead offering evidence that they reversed *unallocated* accruals. The essence of the finding is that the Contractor's system does not account for the differences between monthly allocation rates when attempting to reverse earlier accruals. Regarding the second assertion, we do not agree that the $203,323 in question constitutes an immaterial amount, nor do we feel that material distortions are an unavoidable or acceptable consequence of monthly allocation methods.

The Contractor Claimed $2.1 Million in Costs Incurred and Paid in Another Period

In FY 1998, the Contractor claimed $2,057,565 in costs that were incurred and paid in FY 1999; thus, overstating its FY 1998 costs by that amount. These costs related to an FACP accrual adjustment for information systems and provider education costs. While we consider this claim to be questionable, we are setting these costs aside for CMS resolution.

The FAR 31.201-1 gives the general rule regarding accounting methods. It states that "In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used...."

The FAR 9903.302.1, "Cost Accounting Practice," gives two examples of accounting methods. It states that "Assignment of cost to cost accounting periods,...refers to a method or technique used in determining the amount of cost to be assigned to individual cost accounting periods. Examples of cost accounting practices which involve the assignment of cost to cost accounting periods are requirements for the use of specified accrual basis or cash basis accounting for a cost element." As noted earlier, the Contractor uses the accrual basis of accounting.

The overstatement of costs resulted from the belief of the Contractor officials that the claimed costs are allowable under "section 208" funding. Section 208 of the Departments of Labor, Health and Human Services, and Education, and Related Agencies Appropriations Act of 1993 states that "Funds provided in this Act...may be used for one-year contracts which are to be performed in two fiscal years...." Section 208 was superceded by section 1073 Federal Acquisition Streamlining Act of 1994. Section 1073 states that "The head of an executive agency may enter into a contract for procurement of severable services for a period that begins in one fiscal year and ends in the next fiscal year...." Both section 208 and its successor statute (section 1073) address government obligation accounting by government agencies and have no effect upon accrual accounting rules applicable to contractors. These statutes prescribe when a cost may be charged against appropriated funds by Government agencies, not when a cost may be claimed for reimbursement by contractors.

We are concerned that the Contractor's accounting and reporting for these costs is inconsistent with the FAR and the Cost Accounting Standards Board (same issue as presented in the first finding regarding the $5.6 million accruals). However, we were informed that the Contractor was following CMS instructions. Consequently, we are unable to express an opinion on the allowability of these costs.

Recommendation

We recommend the Contractor design and implement procedures to ensure that costs are included in the proper period. Specifically addressing the $2,057,565, we are setting these costs aside for CMS adjudication.

Auditee Comments

The Contractor cited the criteria for use of section 208 funds and stated that CMS approved several section 208 projects for Medicare Part B in FY 1998. In addition, they say CMS funded a portion of FY 1999's Y2K expenses from FY 1998 funds. These criteria permit funds to be obligated by the Government for 1-year contracts that are to be performed over the course of 2 FYs.

Additionally, they claimed that $1,304,989 of the costs identified related to services rendered in FY 1998 but incorrectly billed by a vendor in FY 1999. Thus, they disagreed with the finding. Second, they claimed that $46,800 of the costs represents a pre-payment for services to be rendered in FY 1999, which was paid in FY 1998. Since the company incurred an obligation in a prior FY, the Contractor claims that the obligation justifies accruing the costs. However, they are willing to claim these costs in FY 1998 or FY 1999, whichever CMS prefers. Finally, they claimed that $705,775 represents FY 1998 section 208 funding for services to be performed in FY 1999. They disagreed that the costs were claimed in the improper FY. However, if CMS prefers, they will accept reimbursement in FY 1999.

In a meeting with Contractor officials, shortly before their response to our draft report was received, one official stated that they would submit documentation from CMS indicating that they were properly accounting for the section 208 funds. The actual response, however, included only a one-page CMS "Star Report" that indicated only that section 208 funds were to be accounted for separately.

OIG Response

In a meeting held at CMS regional office in Atlanta, Georgia, CMS officials stated that they did instruct the Contractor to report the section 208 funding in the way that it was reported. We do not agree with this accounting for the use of funds, but leave it to CMS's discretion.

The Contractor Claimed $677 Thousand for Executive Compensation in Excess of Statutory Limits

The Contractor claimed $677,342 in costs for executive compensation in excess of statutory limits. This total represents $460,934 claimed in FY 1997 and $216,408 for FY 1998. In our

initial assessment, we considered these costs to be unallowable, but based on information provided by the Contractor, we have set these costs aside for CMS to resolve.

The rules applicable to costs that can be claimed for executive compensation have changed in recent years. Section 809, "Compensation of Certain Contractor Personnel," of Public Law 104-201 introduced a limit on the allowability of executive compensation for certain corporate officers to $250,000. This limit applied to costs incurred after September 30, 1996 (i.e., FYs 1997 and beyond). Section 809 applies to "covered contract" defined in 41 U.S.C. 256(l) as "a contract for an amount in excess of $500,000...." Section 808 of Public Law 105-85 delegates the authority for setting limits for executive compensation to the Administrator of the Office of Federal Procurement Policy.

On February 23, 1998, the Administrator published an interim rule in the Federal Register (Federal Acquisition Circular 97-04) increasing the limit from $250,000 to $340,650. This limit "applies to costs of compensation incurred under Federal contracts after January 1, 1998 *regardless of the date of the contract award*" [emphasis added]. On December 18, 1998, the Administrator published (Federal Acquisition Circular 97-10) in the Federal Register making the interim rule law.

The Contractor claimed $677,342 of executive compensation in excess of the mentioned rules. These excess costs are the result of the belief of the Contractor that the relevant rules do not apply to them. They advised us that they would submit an explanation of their rationale and evidence for this belief.

In their response to our draft report, they cited a court case that is the basis for their position. We believe the court case deserves serious consideration and that such consideration is properly deferred to the CMS Contracting Officer. We do not agree that the court case cited is summarily conclusive. However, the Contractor raises sufficient doubt to warrant reclassifying the issue to set aside from disallowance.

Recommendation

While we consider these costs to be excessive, we are unable to express an opinion on their allowability. Thus, we are setting aside the $677,342 for adjudication by CMS.

Auditee Comments

The Contractor presented a court case (available on the internet at http://www.contracts.ogc.doc.gov/fedcl/opinions/2000opin/99-865C.html) that they believe is persuasive authority for their exemption until FY 1999 from the laws cited. The court case and their position hinges on arguable interpretation of the contract language. Basically they do not

believe that the pertinent regulations were in effect at the time the FY 1997 and FY 1998 contracts were executed.

The Contractor Claimed $34 Thousand for Travel Costs in Excess of Federal Travel Regulation Limits

The Contractor utilized a flawed sampling methodology to eliminate unallowable travel costs resulting in $33,624 in overstated costs for FY 1998.

In order to identify and eliminate unallowable travel costs, the Contractor developed its own test procedures and sampling methodology. The sampling procedures, however, had several flaws:

- The sample size was not sufficient for reliable results.
- The sample was not randomly drawn, thus it is not possible to quantify the confidence level or range of precision of sample results.
- The Contractor inappropriately summarized per diem rates. For example, FTR limits for the State of Florida list 27 separate per diem rates based on geographic areas, but the Contractor summarized the whole state into only 3 per diem rates.
- The Contractor assumed without basis, that the ratio of meal, lodging, and incidental costs to total travel costs for the Government Program Division should be the same as for non-divisional travel.
- The Contractor subtracted, without basis, non-divisional costs from divisional costs to arrive at the population of divisional travel costs.

The net result of the various flaws was that, even when attempting to eliminate excessive travel costs after-the-fact, the Contractor continued to overstate travel cost claims.

The FAR 31.205-46(a)(2) states that "Costs incurred for lodging, meals and incidental expense...shall be considered reasonable and allowable only to the extent that they do not exceed, on a daily basis, the maximum per diem rates in effect at the time of travel as set forth in the Federal Travel Regulation...."

We reviewed a sample covering approximately 20 percent of travel by non-Medicare employees allocated to Medicare in FY 1998. Our sample contained an error rate of about 65 percent resulting in overstated travel costs of $33,624. Because a similar methodology was used in the other 3 FYs, we believe the other years could be affected.

This overstatement was caused by:

- the Contractor's failure to follow its own existing procedures to limit costs to FTR limits,

- errors in the Contractor's sampling methodology to fully estimate and eliminate from Medicare allocation costs in excess of FTR limits, and
- the Contractor's failure to maintain sufficient detail on the purpose of the travel to document the nature of the travel and its relation to Medicare.

Recommendation

As a result, we recommend that the Contractor:

- Reduce its FY 1998 claim by $33,624.
- Ensure that its own policies and procedures related to limiting claimed travel costs to FTR limits are followed.
- Correct its current sampling procedures or implement new procedures that limit travel cost allocations to Medicare in accordance with FTR.

Auditee Comments

The Contractor disagreed with this finding. Their first position was that our methodology to review travel was flawed, primarily because we purportedly only focused on non-Medicare cost centers (indirect) when Medicare cost centers (direct) account for 79 percent of the travel charged to Medicare. Thus, our sample was not representative. Their second position was that their sampling methodology was appropriate. They also stated that their use of three per diem rates for the whole State was economical and efficient. They added that the process of applying FTR per diems were tedious and time-consuming, and they claim that the administrative burden of doing so was not worth the potential cost savings.

OIG Response

Regarding the Contractor's first position, we reviewed both direct and indirect costs without an emphasis on either cost. For direct costs, we evaluated the same 43 transactions that the Contractor originally used to review direct travel costs. We used the same sample transactions because we were attempting to validate the Contractor's findings. Our review disclosed overpayments where the Contractor's efforts did not.

Regarding their second position, if the Contractor's sampling methodology was appropriate we would not have found questioned costs. Our results indicate the Contractor's methods do not adequately identify non-allocable costs.

The $33,624 indirect travel cost adjustment is based on the tested transactions of reimbursed costs and did not involve any projection.

Auditors Set Aside $96 Million in Costs Due to Lack of Supporting Documentation

Based on our review of FY 1998 costs, we are setting aside for CMS adjudication an estimated $96 million in costs claimed in FY 1995 through 1998.

The agreed upon protocol of our audit with the Contractor was to select and review a sample of FY 1998 costs claimed by the Contractor. Based on the results of this judgmental sample, we were to select a sample of costs for testing in FYs 1995 through 1997. The Contractor, however, failed to provide the auditors with documentation for costs and/or access to the allocation system to support $20,101,368 in FACP claims for FY 1998, consisting of $1,228,398 of ROI costs, $7,567,934 in Non-Chargeback indirect costs, and $11,305,036 in Chargeback indirect costs. We were unable to express an opinion on these costs. The figures represent the total amount claimed for these costs.

Considering the audit environment and lack of detailed supporting documentation during our review of FY 1998 costs, we noted no indications that our results would be materially different by conducting tests of costs claimed in FYs 1995 through 1997. Thus, we did not review costs claimed in FYs 1995 through 1997. Alternatively, using the results of our FY 1998 tests, we made estimates of cost totals for which we could not render an opinion on in FYs 1995 through 1997.

The $96 million is based partially on estimates and partially on actual cost totals, depending on the availability of Contractor records. We were able to identify the ROI costs on the FY 1995 through FY 1997 FACPs; however, we were unable to quantify two indirect costs, the Non-Chargeback costs and the Chargeback costs claimed on these FACPs. Thus, we estimated the Non-Chargeback costs and Chargeback costs claimed in FYs 1995 through 1997.

We quantified these set aside costs based on the best documentation available. We recognize that the estimated portion of these set aside costs may vary from actual costs, but we consider them the best alternative to demonstrate the magnitude of uncertain costs in the years we did not review. Again, this was brought on by the audit environment.

Based on our FY 1998 results, we are setting aside $95,833,029 claimed in the three categories listed below during FYs 1995 through 1998. This amount represents the following:

Non-Chargeback Indirect Costs – We did not receive requested documentation to support $7,567,934 of indirect costs claimed for FY 1998. Based on this condition, we estimated the total costs for set aside for FYs 1995 through 1998 to be $39,500,384 (see Appendix C for annual cost totals).

Chargeback Indirect Costs – We did not receive requested documentation to support $11,305,037 of chargeback costs claimed for FY 1998. Based on this condition, we estimate the total costs to be set aside for FYs 1995 through 1998 to be $49,194,976.

Return on Investment – We did not receive requested documentation to support the computation of $1,228,398 of ROI costs claimed for FY 1998. Based on this condition, we quantified the ROI costs claimed for FYs 1995 through 1998 and set aside $7,137,670.

In addition to the above referenced set aside amounts, we also set aside $680,044 representing an FACP adjustment. We received minimal documentation in support of the $680,044. Though this amount appears to be related to the section 208 issues discussed previously, we have set it aside principally because we are unable to determine the proper period it should be reported. Contractor records indicate that this amount was invoiced on November 10, 1998 and approved for accrual on January 22, 1999. However, a memo related to the invoice states "milestones were completed in September and October (1998)." The Contractor did not provide sufficient information to determine what portion of the cost were related to FY 1998. Thus, we set aside the entire amount.

Recommendation

We are unable to express an opinion on an estimated $96,513,073 ($95,833,029 + $680,044) of costs claimed in FYs 1995 through 1998. Therefore, we are recommending these costs be adjudicated by CMS. We also recommend that the Contractor submit the necessary documentation to the CMS Contracting Officer to properly document the allowability as well as the allocability of costs set aside in this audit. If proper documentation is not received, then these set aside costs should be disallowed.

Auditee Comments

The Contractor did not agree with the majority of FY 1998 findings. Their position is they have provided documentation to support these questioned costs. Even where they agree with the draft report, they believe that the Government has not presented evidence that the issues existed. Therefore, set aside amounts should be removed from the report.

The Contractor specifically addressed ROI costs. They explained their procedures for recording ROI and provided additional documentation that we reviewed.

OIG Response

The Contractor was supplied exceptions and/or work papers detailing our disallowances prior to our leaving the audit site on May 12, 2000. When the draft report was issued, auditors held

meetings with the Contractor to explain set aside costs and to answer their questions concerning these costs. They were informed that the set aside costs were based on the actual direct and indirect costs claimed in the FACPs during this audit period. In our opinion, the Contractor had ample opportunity to understand our issues and provide the supporting documentation requested. However, they have not provided substantive support for the costs nor the allocability of those costs.

The Contractor Should Improve Internal Controls Over Reported Costs

The Contractor needs to improve various internal controls to ensure the reliability of the amounts claimed on the FACP. In some cases, the Contractor was unable to reconcile amounts reported on FACPs to its accounting records. Examples included:

- Differences between the FY 1998 carrier subcontract costs ($12,332,369 per FACP versus $18,006,452 per books).
- Negative balances in the FY 1998 carrier EDP and building occupancy chargeback accounts of $1,871,303 and $2,354,987, respectively.
- FY 1998 carrier Year 2000 (Y2K) subcontract costs of $1,421,794 per the FACP versus at least $6,528,990 per books.

We also noted a lack of controls over what invoices were covered by forward funding (section 208) and the extent to which existing forward funding authority had been used or exceeded.

The FAR 31.201-2(d) states that "(a) contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that the costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles...." More specifically, Article XX of the Contract states that "The Carrier shall maintain adequate accounting records covering the use of funds...." under the contract. In addition, Article XVI of the Contract states that "The Carrier may shift funds between line items in the Notice of Budget Approval. However, the cumulative amounts shifted to or from any line item may not exceed 5 percent of the largest approved amount for that line item without prior written approval of the Secretary."

Except for the negative balances, the conditions occurred because the Contractor did not perform routine reconciliation and reviews of FACP information. The negative balances were caused by a systemic error.

Because the Contractor was unable to reconcile all amounts reported on FACPs to the amounts in its accounting records, the reliability of the costs and activity classifications listed on the FACP is in doubt. Lack of reliability means that:

- The Contractor's compliance with budget provisions is questionable.
- Meaningful analysis by CMS of the Contractor's reported costs is impaired, if not precluded altogether.
- The CMS's ability to effectively manage the contract and ensure compliance with relevant laws is at risk.

Recommendation

We recommend that the Contractor design, document, and implement procedures for routine FACP reconciliation and reviews.

Auditee Comments

The Contractor did not specifically address internal controls in their response.

Follow-Up of Y2K Findings From Previous Reports

The OIG/Office of Audit Services (OAS) issued two previous audit reports on the Contractor for FY 2000 (Y2K) audits. The first report (A-05-99-00008) was issued by OIG/OAS Region V on June 8, 1999. The second report (A-04-99-02159) was issued on March 17, 2000 by Region IV. The first report identified $198,010 of unallowable costs and recommended costs be reimbursed by the Contractor. The second report identified $1,401,233 in unallowable costs claimed and $2,618,499 in questionable costs that were set aside for adjudication by CMS.

We contacted the CMS regional office officials and asked what had been done concerning the collection of these funds. They were unaware of any refunds made by the Contractor through any of its FACP filings concerning the findings of either of the Y2K audits.

In reviewing the audits, we noted some possible duplication of adjustments between these two audits. The possible duplicate adjustments were removed so the Contractor would repay the actual amount per audits. The net amounts addressed by this finding are $1,439,022 for unallowable costs and $2,618,499 for set aside costs. For more details, please refer to Appendix E which details the adjusted costs as well as the set aside costs.

Recommendation

Since no settlement or attempt at settlement has been made, the Contractor should repay these funds by decreasing its next FACP filing by $1,439,022. The CMS Contracting Officer should review the $2,618,499 set aside by the audits to determine if the costs are reimbursable, and if they are properly stated. These figures are not a part of our totals for recommended

disallowances and set asides because they have been previously cited in the prior reports. This recommendation serves only to reconcile the prior reports to this report for settlement purposes.

Auditee Comments

The Contractor disagreed with this finding. They indicated that the two previous Y2K audits have been settled and that CMS regional officials were notified of this settlement. They state that they reduced the administrative costs recorded on the IER to the extent it agreed with the audit report.

OIG Response

The Contractor's response does not offer any evidence for us to verify their statements. They merely make statements which sound as though some adjustments have been made, but their response is not specific enough to determine exactly how much of the questioned costs were reduced. Another audit of IERs would be required to determine their response to the reports. Again, in lieu of adequate support, only CMS officials know the extent of the Contractor's cooperation.

Conclusion

In summary, the Contractor should provide restitution to the Medicare program for the $5,158,255 of previously reimbursed costs that were determined to be non-allowable during the course of this audit. Of the $104,836,580 that we set aside for adjudication by CMS, we noted that the majority of these costs were related to the Contractor's failure to provide requested information and needed access. The majority of the set aside amount, $88,695,359, is related to the Contractor's indirect costs, either chargebacks or those costs processed under their allocation system. Given the significant amount of the indirect costs in question, we recommend that the Contractor develop an indirect cost rate that will reasonably allocate indirect costs to Medicare.

We also recommend that in future audits, the Contractor explicitly acknowledge and act consistent with CMS's and the Secretary's (or their delegate's) right to unrestricted, complete, and timely access to information supporting costs claimed for reimbursement under their Medicare contracts.

The CMS Contracting Officer should request substantive documentation from the Contractor to support costs set aside in this audit. In our opinion, if necessary documentation is not received, set aside costs in this audit should be disallowed.

Amounts Claimed, Disallowed, and Set Aside

FY 1998	Claimed	All Other	Disallowed	Set Aside	Unaudited
Part A (Intermediary)	$ 19,753,235	$ 9,055,538	$ 362,143	$ 9,593,597	$ 741,957
Part B (Carrier)	73,901,174	48,657,389	3,787,492	19,050,388	2,405,905
Total FY 1998	**$ 93,654,409**	**$ 57,712,927**	**$ 4,149,635**	**$ 28,643,985**	**$ 3,147,862**

FY 1997	Claimed	All Other	Disallowed	Set Aside	Unaudited
Part A (Intermediary)	$ 19,810,152	$ 13,433,857	$ 184,542	$ 5,116,360	$ 1,075,393
Part B (Carrier)	71,653,898	50,194,204	824,078	18,115,029	2,520,587
Total FY 1997	**$ 91,464,050**	**$ 63,628,061**	**$ 1,008,620**	**$ 23,231,389**	**$ 3,595,980**

FY 1996	Claimed	All Other	Disallowed	Set Aside	Unaudited
Part A (Intermediary)	$ 16,733,337	$ 11,096,968	$ -	$ 5,048,458	$ 587,911
Part B (Carrier)	78,001,589	53,544,958	-	22,187,437	2,269,194
Total FY 1996	**$ 94,734,926**	**$ 64,641,926**	**$ -**	**$ 27,235,895**	**$ 2,857,105**

FY 1995	Claimed	All Other	Disallowed	Set Aside	Unaudited
Part A (Intermediary)	$ 16,172,195	$ 10,853,713	$ -	$ 4,712,330	$ 606,152
Part B (Carrier)	75,885,960	51,834,058	-	21,012,981	3,038,921
Total FY 1995	**$ 92,058,155**	**$ 62,687,771**	**$ -**	**$ 25,725,311**	**$ 3,645,073**

FY 1995 to FY 1998	Claimed	All Other	Disallowed	Set Aside	Unaudited
Part A (Intermediary)	$ 72,468,919	$ 44,440,076	$ 546,685	$ 24,470,745	$ 3,011,413
Part B (Carrier)	299,442,621	204,230,609	4,611,570	80,365,836	10,234,607
Total FY 1995 to FY 1998	**$ 371,911,540**	**$ 248,670,685**	**$ 5,158,255**	**$ 104,836,580**	**$ 13,246,020**

NOTE: In all schedules, instances of rounding variances were noted. These differences have been reviewed and deemed immaterial.

Recommended Disallowances

Recommended Disallowances: FY 1998		Med A		Med B		FY1998 Total	Notes
Direct Costs:							
FACP Adjustments: Accruals	$	-	$	100,000	$	100,000	A
Travel		3,272		7,945		11,217	
Furniture and non-EDP Equipment		-		40,542		40,542	C
Payroll Adjustments ("Y" adjs.)		-		7,686		7,686	
Subtotal Direct Costs	**$**	**3,272**	**$**	**156,173**	**$**	**159,445**	
Indirect Costs:							
Cost Allocation System							
Allocations Contrary to FAR		287,861		1,007,091		1,294,952	
Cost centers not benefitting Medicare		128,907		39,368		168,275	
Conflicting sources of allocation data		(115,449)		522,086		406,637	
Reversals at less than accruals		52,602		150,721		203,323	
subtotal, Cost Allocation System		**353,921**		**1,719,266**		**2,073,187**	
Travel		4,951		17,456		22,407	
Facilities & Occupancy (cc955)		-		158,829		158,829	B
EDP Equipment (cc810 and 881)		-		1,205,959		1,205,959	B
Telephone (cc381)		-		107,592		107,592	B
Furniture & Equipment		-		89,832		89,832	C
Materials & Supplies		-		330,643		330,643	C
Miscellaneous		-		1,741		1,741	C
Subtotal Indirect Costs		**358,871**		**3,631,318**		**3,990,190**	
Total Recommended Disallowance FY 1998	**$**	**362,143**		**3,787,492**		**4,149,635**	

Notes: A = FACP accrual adjustments
B = Charge-backs (cc381, 810, 881, and 955)
C = Other disallowances due to failure to provide information

Recommended Disallowances: FY 1997	Med A	Med B	FY 1997 Total	Notes
Cost Allocation System				
Allocations Contrary to FAR	146,552	580,294	726,846	
Cost Centers Not Benefitting Medicare	37,990	154,474	192,464	
Lobbying	-	89,310	89,310	
Total Recommended Disallowance FY 1997	184,542	824,078	**1,008,620**	

Total Recommended Disallowances FY1998 and FY1997	Med A	Med B	Total	Notes
Failure to Provide Requested Support and Needed Access				
FACP accrual adjustments	$ -	$ 100,000	$ 100,000	A
Charge-backs (cc381, 810, 881, and 955) *	-	1,472,380	1,472,380	B
Other	-	470,444	470,444	C
subtotal, failure to provide information	-	**2,042,824**	**2,042,824**	E
Cost Allocation System				
Allocations Contrary to FAR	434,413	1,587,385	2,021,798	
Lobbying	-	89,310	89,310	
Cost Centers Not Benefitting Medicare	166,897	193,842	360,739	
Reversals at Less Than Accruals	52,602	150,721	203,323	
Conflicting Sources of Data	(115,449)	522,086	406,637	
Subtotal Cost Allocation System	**538,463**	**2,543,344**	**3,081,807**	
Travel	8,222	25,402	33,624	
Total Recommended Disallowances FY1998 and FY1997	**$ 546,685**	**$ 4,611,570**	**$ 5,158,255**	

Notes: A = FACP accrual adjustments

B = Charge-backs (cc381, 810, 881, and 955)

C = Other disallowances due to failure to provide information
($48,228 is the direct cost and $422,216 is indirect costs.)

* = cc381, 810, 881, and 955 are the following respective cost centers:
telephone, EDP, system, and building.

E = The Contractor overstated its claim for FY 1998 administrative costs by $2,042,824.

Recommended Set Asides

Set Asides: FY 1998		**Med A**		**Med B**		**FY 1998 Total**
Return on Investment (ROI)	$	245,627	$	982,771	$	**1,228,398**
Other direct (FACP adjustments)		-		680,044		**680,044**
Section 208 Funding Issues		4,605,993		3,040,172		**7,646,165**
Non-Charge-back Indirect Costs		1,809,776		5,758,158		**7,567,934**
Executive Compensation		46,450		169,958		**216,408**
Charge-backs		2,885,751		8,419,286		**11,305,037**
Total Set Asides: FY 1998	**$**	**9,593,597**	**$**	**19,050,388**	**$**	**28,643,985**

Set Asides: FY 1997		**Med A**		**Med B**		**FY 1997 Total**
Return on Investment (ROI)	$	406,905	$	1,329,927	$	**1,736,832**
Non-Charge-back Indirect Costs		1,723,390		6,825,299		**8,548,689**
Executive Compensation		91,999		368,935		**460,934**
Charge-backs		2,894,066		9,590,868		**12,484,934**
Total Set Asides: FY 1997	**$**	**5,116,360**	**$**	**18,115,029**	**$**	**23,231,389**

Set Asides: FY 1996		**Med A**		**Med B**		**FY 1996 Total**
Return on Investment (ROI)	$	498,475	$	1,778,690	$	**2,277,165**
Non-Charge-back Indirect Costs		2,105,409		9,968,242		**12,073,651**
Charge-backs		2,444,574		10,440,506		**12,885,080**
Total Set Asides: FY 1996	**$**	**5,048,458**	**$**	**22,187,437**	**$**	**27,235,895**

Set Asides: FY 1995		**Med A**		**Med B**		**FY 1995 Total**
Return on Investment (ROI)	$	333,380	$	1,561,895	$	**1,895,275**
Non-Charge-back Indirect Costs		2,016,353		9,293,757		**11,310,110**
Charge-backs		2,362,597		10,157,329		**12,519,926**
Total Set Asides: FY 1995	**$**	**4,712,330**	**$**	**21,012,981**	**$**	**25,725,311**

Set Asides: FY 1995 to FY1998		**Med A**		**Med B**		**Total**
Non-Charge-back Indirect Costs	$	7,654,928	$	31,845,456	$	**39,500,384**
Charge-backs		10,586,988		38,607,988		**49,194,976**
subtotal, charge-backs and other indirect costs		**18,241,916**		**70,453,444**		**88,695,359**
Return on Investment (ROI)		1,484,387		5,653,283		**7,137,670**
subtotal, set asides due to lack of information		**19,726,303**		**76,106,727**		**95,833,029**
Other direct (FACP adjustments)		-		680,044		**680,044**
Section 208 Funding Issues		4,605,993		3,040,172		**7,646,165**
Executive Compensation		138,449		538,893		**677,342**
Total Set Asides: FY 1995 to FY 1998	**$**	**24,470,745**	**$**	**80,365,836**	**$**	**104,836,580**

Issues Encountered During the Audit

This appendix addresses examples of the Contractor's lack of cooperation during this audit and also addresses some of the Contractor's responses to our draft report that did not focus on specific audit findings, but rather were attacks on the conduct of the audit and the auditors. We believe such a disclosure was warranted to demonstrate the audit environment under which the auditors operated, and to better explain the results in this report.

As these comments indicate, the audit environment was less than one would expect from a Federal contractor doing significant business with the Government. Normally, we would not even consider such comments to deserve any attention. However in this case, we felt it necessary to present as full a picture as possible for CMS's consideration in resolving this report.

Contractor Cooperation Was Lacking

In the body of this report, we have made references to the Contractor's general lack of cooperation regarding our requests for documents and access to information. Many of our requests were items necessary for us to obtain reasonable assurance concerning the propriety of both direct and indirect costs. Some examples of our requests include:

- Access to the cost allocation system and evidence of allocation methodologies.
- Requests for invoices concerning telephone, postage, furniture and equipment, and materials and supplies.
- Verification of chargeback activities and methodologies.
- FACP reconciliation.
- Minutes of the Board of Directors meetings.

To illustrate the magnitude of the Contractor's lack of cooperation, we have included the following details of our efforts to obtain the following information from the Contractor Management letters and access to public auditor work papers.

- Internal audit reports and records of time spent.
- Documentation of executive compensation.
- Y2K costs.
- Invoices related to non-executive compensation including professional services and subcontracts.

Management Letters and Public Auditor Work papers. We verbally requested access to the management letters and internal control work papers of the public auditor in our entrance conference on October 14, 1999 (followed up with a written request on November 3, 1999). Contractor officials gave us a partial response on December 10, 1999 and a complete response by December 29, 1999. Thus, it took the Contractor 2.5 months to supply the management letters.

Regarding the public auditor's work papers, Contractor officials gave us a contract phone number with the public auditor, Price Waterhouse and Cooper (PwC), in mid-November 1999, and we traded various phone calls with the public auditor in early December. On December 16, 1999, PwC auditors advised us that Contractor officials would need to provide written consent for us to view the internal control work

papers. They granted us permission on February 25, 2000, and we eventually met with PwC on February 29, 2000. Thus, it took more than 6 weeks for the Contractor to simply grant access to the public auditor (not counting the time we waited for a contact name and phone number).

Internal Audit Reports and Records of Time Spent. We verbally requested a complete listing of internal audit reports and access to those reports in our entrance conference on October 14, 1999. We then followed-up with written requests on November 3, 1999, December 15, 1999, and January 7, 2000. We also explicitly requested in our December 15th request that the Contractor provide us with the hours spent on the audit projects.

On November 8, 1999, we received copies of seven reports. When we questioned whether this constituted all internal audit reports, Contractor officials stated that these were all the Medicare-related reports. When we requested a list of all internal audit reports, they told us on December 13, 1999, that such a list would be denied. On December 22, 1999, they informally advised that they would provide us with those reports that they deemed relevant to Medicare.

Meanwhile, we continued to press Contractor officials for a list of all internal audit reports that included the time spent on each audit project. On January 21, 2000, we received the complete listing for FY 1998 and FY 1997. Thus, it took the Contractor over 3 months to supply a list of internal audit reports. The listing revealed that there were many more reports related to Medicare than the original seven we were given. On February 8, 2000, we received the listing of hours by project that we had requested (over 2 months after we had requested it). The listing of hours demonstrated that the Medicare benefits claimed for Internal Audit were overstated by 20 to 30 percent.

Executive Compensation. Our inquiry into executive compensation began with a December 6, 1999 written request for substantiation of specific journal entry transactions for cc368 (Management Incentive Program). Like other requests, we followed up the initial request with multiple verbal and written requests. We did not receive any documentation until January 21, 2000 (6 weeks after our initial request). At that time, Contractor officials permitted us to view the available documentation. We were not, however, allowed to copy any of the documents detailing individual bonuses. Our subsequent requests for copies were denied.

On January 7, 2000, we submitted a written request for compensation related to specific executives to test for compliance with the statute limiting claims for executive compensation. This request also cited the need for information by cc in order to determine the amount actually allocated. In our January 20, 2000 meeting with Contractor officials, they stated that they would not provide the requested information without a letter from OIG describing the protections we would maintain over the executive compensation information. We complied with their request and provided them with a letter. This information, however, is a matter of public record[1] and was filed by the Contractor with the State of Florida Department of Insurance. Nevertheless, we did not receive any of the requested information until February 29, 2000. We did not receive the complete compensation portion of the request until April 14, 2000. All the information submitted by the Contractor was in CY format as the Contractor asserts that it

[1]In fact, information on executive compensation is published locally and on the Internet. For example, the June 2, 1997 issue of the Jacksonville Business Journal http://www.bizjournals.com/jacksonville/stories/1997/06/02/story1.html] lists the compensation for 11 Contractor executives.

is not possible to produce the information in FY format.[2] We never received the requested information concerning support for how each executive's pay was allocated.[3]

Y2K Costs. On January 3, 2000, we requested in writing that the Contractor provide us with a reconciliation between a FY 1998 Med B Y2K costs claimed and Y2K costs it reported on the FY 1998 Med B FACP. On January 18, 2000, Contractor officials provided us with the following statement in lieu of a reconciliation:

"For this invoice, Y2K expenses totaled approximately $1.1 million and were included in the over $3 million located in the 17100 series of activities [reported on the FACP]." In other words, we received an unsupported assertion that Y2K costs were reported correctly despite the difference between the $3 million figure cited and the amounts actually reported on the FACP (the FY 1998 Med B FACP reflects about $1.4 million in subcontract Y2K costs). We followed up the January 3rd request with a second request on January 26, 2000, restating our original request. This request said, in effect, that an unsupported assertion is not equivalent to a reconciliation. The Contractor has yet to provide a meaningful response to this request.

Non-Executive Compensation. We requested in writing, supporting documentation (invoices, copies of contracts, etc.) for 74 separate amounts recorded in the general ledger. In order to reduce the audit burden on the Contractor for this cost category, we specifically selected transactions with common sources of information (i.e., multiple transactions having the same invoice number or reference number). Thus, the Contractor could secure a single source of information to verify multiple transactions and reduce the burden on its staff.

The 74 transactions had 51 distinct sources of documentation (i.e., 23 of the amounts involved multiple charges for a single invoice, a single payroll report, etc.). Thus, the effective request was for support for a sample of 51 items. We asked for the information in a series of requests on December 6 through December 10, 1999. The Contractor's response for the initial request and follow-up requests was as follows:

- Payroll Transactions and Related Journal Entries: We requested in writing a total of 13 unique source items to include 11 regular payroll entries and 2 manual entries. Of the regular payroll entries, we did not receive any documentation until January 18, 2000. This documentation consisted of payroll reports with a total of 36 pages known to be missing plus an entire payroll report missing. The missing pages meant that we had received complete documentation on only four items. When we asked for an explanation for the missing pages, the Contractor gave no response. On February 22, 2000, the Contractor supplied five of the missing pages related to two separate payroll reports. The missing pages supplied did not complete either report. On March 2, 2000, we received additional missing pages sufficient to complete the initial request for five more items. On March 20, 2000, we received additional missing pages sufficient to

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[2]The Contractor offered no evidence for the assertion regarding the limitations on FY data. We are skeptical of their assertion since the majority of the compensation information we requested constitutes wages required to be reported with the Internal Revenue Service on a quarterly basis (i.e., as part of the Form 941 Quarterly Employment Tax Return). Such quarterly information ought to facilitate a conversion from a December 31 yearend to a September 30 yearend.

[3]For certain executives, we were able to develop the information needed as part of an inquiry into the cost allocation system. For other executives, we were forced to assume a G&A allocation rate.

complete the initial request on the remaining two items. Thus, it took the Contractor 3.5 months to complete the original request of 11 regular payroll entries.[4]

- Of the two manual journal entries requested, we did not receive any documentation until December 21, 1999 (these copies were gathered by OIG staff). The documentation received on these two was only partial. We did not receive the supporting time records until February 22, 2000. Thus, it took the Contractor 3 months to complete the initial request for the two manual entries. The supporting time records had discrepancies, and we never received any explanation of these discrepancies.

- Vendor Invoices and Related Journal Entries: Of the 38 unique items requested in writing, we did not receive any documentation until December 20, 1999, and then only because we volunteered a staff auditor to assist with pulling the documentation. By January 5, 2000, we had received 30 of the original 38 items requested, but none of these 30 had the requested explanation of the services rendered, something we requested in the original request. Thus, it took the Contractor nearly a month to give a partial response with significant information missing from even that partial response.

We received an initial response on one item on April 10, 2000, and another on June 7, 2000. We never received any response on the remaining 6 items, nor have we received a meaningful response to our request for an explanation of services rendered on 28 of the 32 items. During March, the Contractor tentatively offered a document as evidence of services rendered; the document gave only brief phrases (e.g., "Network Development" as an explanation of services rendered for costs recorded in a cc entitled "Network Development." Since we rejected that as sufficient evidence, we were not permitted to keep a copy of that document.

- Vendor Contracts: As part of our original request of 51 items, we asked in writing for 13 vendor contracts. We did not receive the first vendor contracts until December 20, 1999 (we received two at that time). On January 18, 2000, Contractor officials stated that we would not receive one of the contracts because the claimed cost was not related to Medicare and was adjusted out. On February 18, 2000, we received a copy of a third vendor contract. We have not received the remaining nine vendor contracts to date. Thus, the Contractor took 2.5 months to submit 3 vendor contracts, and disclaim submitting a fourth with the majority of the contracts (about 70 percent) not being submitted at all.

Payroll Taxes: On January 26, 2000, we requested in writing, support for payroll tax entries for six sample employees for a single pay period. This support was necessary because the payroll reports the Contractor provided us (called labor distribution reports) do not permit a reconciliation of payroll tax amounts to wages. The missing data is contained in a separate payroll report (the "payroll register"). We did not receive the requested support until March 20, 2000. Thus, it took the Contractor nearly 2 months to provide support for 6 payroll tax amounts.

- Payroll Adjustments: On January 26, 2000, we requested in writing support for several adjustments to the payroll entries labeled "Y adj." These adjustments appear to be a "plug" number because they were computed in the documentation we were given as the difference between the payroll reports and the

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[4]We encountered the same problem with missing pages in our inquiry into the cost allocation system. We received a report entitled "Admin2 Allocation Report for Period 2" for cc368. This report was nominally 374 pages long, but was missing 30 pages at irregular intervals, pages 50 to 56, 129 to 136, 217 to 224, and 265 to 272. We asked for an explanation for the missing pages, but never received it.

general ledger entry. We received no response until March 3, 2000. At that time, Contractor officials informed us that the effort needed to support the entries was not cost-effective (the Contractor estimated that it would require 3 weeks of work). The Contractor Officials further stated that it was their opinion that the general internal controls work, and related internal control certifications were sufficient to support the questioned "Y" adjustments. Thus, it took the Contractor 5 weeks to decide that they were going to deny our request.

Other Contractor Comments

The Contractor's response to our draft report included assertions that were directed at the audit team and the performance of the audit. We believe these assertions are without merit and warrant our response. We will begin with a general overview of the issuance of the draft report and the Contractor's response.

On June 18, 2001, we issued our draft report. The report included as an appendix a six-page narrative describing a few of many instances of the Contractor's lack of cooperation during our fieldwork. This lack of cooperation included their failure to provide access to requested supporting documentation on a timely basis, if at all.

Once the draft report was issued, Contractor officials verbally informed us of their displeasure with the report. They indicated that they disagreed with almost all of the findings but they were the most adamant in denying their lack of cooperation and inquired about the possibility of removing the Appendix D from the final report. They acknowledged, however, that they were at least partially at fault and were giving the resolution of the audit their highest priority.

The Contractor subsequently requested, and was granted, a 30-day extension to provide a response to the draft report. We agreed to be available to meet with them during the response period to answer any questions they had regarding the draft findings, including the documentation that would be necessary to resolve the draft findings. We did this on three occasions.

On August 17, 2001 we received the Contractor's response to the draft report. The response was composed of:

- a two-page letter from the president of First Coast Service Options, Inc. (FCSO), Blue Cross Blue Shield of Florida's (BCBSFL) subsidiary that now administers the contract. We did not receive any correspondence from the president of BCBSFL to whom the report was addressed.
- a 100-page, double-spaced, response to the findings.
- six, three to four-inch binders contained what was suggested to be additional supporting documentation.

The letter from FCSO's President was very cordial and somewhat conciliatory. The response to findings, however, had an entirely different tone. For instance, it contained accusations that the audit staff was incompetent and also contained undertones of possible legal action if the appendix regarding lack of cooperation was not removed from the final report. Considering the nature of the response to the findings, we believe the Contractor's more critical comments deserve our consideration. Therefore, we have cited some of these comments below and offer our comments in rebuttal. The Contractor's comments are in italics, followed by our response.

1. "The audit team lacked experience...particularly considering the size and complexity of our Medicare contracts."

The above referenced Contractor statement lacks substance. The Contractor's administrative costs fall under the FAR, Title 48, not Medicare regulations (Title 42). In addition, nothing is particularly unique or complex about the costs that were claimed, nor in auditing the use of a cost allocation system, a feature common to Federal contracts. The Senior Auditor has been involved in auditing Contractor costs for the past 15 years. The Auditor-in-Charge had 18 years of auditing experience, 13 years of which have been in auditing Medicare cost allocations. In addition, the senior staff member of the team has worked in another audit unit whose threshold for work responsibility was Federal contracts exceeding $1 billion and who received an award from the Virginia Society of Certified Public Accountants for placing in the top 10 scores for the Virginia November 1995 Certified Public Accountant (CPA) test. What makes the Contractor's comments peculiar is that the Chief Financial Officer of FCSO contacted our management subsequent to this response, requesting another audit to set an indirect cost rate and also requested that the above referenced auditors be the ones that complete the second audit based on their combined knowledge.

2. "Only after BCBSFL requests in January 2000, did the Company have the opportunity to have regular meetings with the auditors...; the company was led to believe that the audit was progressing to OIG's satisfaction."

The first meetings occurred in mid-December 1999 at our request because of our repeated observations that the Contractor was not being responsive to our information requests. We produced and submitted several reports regarding information requests from that point until late January, after which we ceased seeking regular meetings since these meetings did not produce material improvement in Contractor cooperation. The Chief Financial Officer for FCSO stated that obtaining documentation from their corporate/private side was difficult because they did not understand the scope of this audit. He notified the auditors that he would assume the responsibility of acting as a liaison for obtaining requested documentation.

3. "BCBSFL did not have an adequate opportunity to explain or resolve any of the preliminary findings...since written descriptions of the issues/findings were just provided during the days immediately preceding May 12, 2000."

We kept the Contractor informally notified of potential findings as the audit proceeded. The written descriptions were merely the formal written notification that normally occurs at the exit conference. The Contractor had months to explain and resolve issues, and fieldwork ceased precisely because the Contractor failed to provide the requested explanations.

4. "At the [May 12] meeting, the Company was told that the findings were merely preliminary and would be amended or eliminated once supporting documentation or missing information was supplied. Several boxes of additional material were subsequently sent to the auditors...[and] the audit report does not reflect...this material...."

Contrary to this assertion, the draft report incorporated the cited material. The material did not significantly alter the findings in the draft report.

5. *"The signed copies of the management letters that were originally provided contained all of the substantive information that should have been necessary for the on-site work."*

The letters were missing the public auditor's evaluation of the materiality of the weaknesses identified at the Contractor. The Contractor's attempt to judge what should be necessary to an auditor is reflective of a consistent belief that an auditor's independence and judgment as to what is necessary is subject to circumscription by an auditee.

6. "This second set of workpapers was produced even though the audits did not relate to Medicare but rather to an audit for the FEP (sic)...The results of these audits produced no significant findings with respect to the allocation philosophies or practices of BCBSFL...The audit team was responsible for most of the delay."

The Federal Employee Plan (FEP) workpapers related to the same cost allocation system shared by FEP and Medicare, and are thus relevant. In fact, the public auditor found a significant error in the cost allocation system that resulted in the Contractor refunding $1,271,052 to the FEP. The error is especially significant, given that FEP is a much smaller program than Medicare. The interesting aspect to the error was that it involved an over-allocation to FEP, caused by costs that were not allocated to FEP. This is contrary to repeated claims by the Contractor that costs that do not allocate to a particular customer do not affect costs that do allocate to that same customer. The public auditor's work papers were not especially detailed, so we requested the details on the finding to include the evidence that the error in the allocation system was corrected. Consistent with the Contractor's performance, it failed to provide the requested documentation.

The Contractor's claim that the audit team was responsible for most of the delays is not factual, given that they barred the audit team from meeting with the public auditor from December 16, 1999 until February 25, 2000. As noted in the draft, we met with the public auditor 4 days after receiving the Contractor's permission.

Summary of Audit Work Performed in Order to Determine Y2K Settlement From Previous Audit

We reviewed the previous two Y2K audits performed at the Contractor, and found that no settlement has been made concerning either of the audits by the Contractor through their FACP as required by the Program Memorandum for Intermediaries and Carriers (Transmittal AB-00-16) issued by CMS in March 2000. A summary of the auditor's review is as follows:

I. Y2K audit reports and date of issue:

(a) Audit of Administrative Costs Reported by Selected Contractors for Year 200 (Y2K).
CIN: A-05-99-00008
Date Issued: June 8, 2000

(b) Audit of Costs Reported by First Coast Service Options, Inc. for Year 2000 (Y2K).
CIN: A-04-99-02159
Date Issued: March 17, 2000

II. The nature and extent of contact with CMS regional office staff concerning their actions taken on Y2K recommendation:

On February 20, 2001, we spoke with CMS regional office personnel responsible for the Contractor's FACPs and asked what follow-up had been performed on Y2K audits. They stated that, per their review of the FACPs, settlement had not been made, nor had they noted any disagreement mentioned concerning these audits by the Contractor as required by the above referenced Program Memorandum.

The March 2000 CMS Program Memorandum instructed the intermediaries and carriers to adjust their FACPs for Y2K audit adjustments, or, if they disagreed with any of the audit findings, to continue to allocate Y2K costs in accordance with budgetary guidelines released by CMS. In the last instance, they should note in the remarks section of the FACP a description of their actions regarding Y2K audit adjustments. Once a risk assessment or an audit of all Contractors' total expenditures has been completed, CMS will make a final determination of all disputed Y2K costs. Any resulting adjustments will be reflected in the closing agreement related to the FACP. Based on conversations with CMS personnel, the Contractor has not attempted to comply with the CMS memo dated March 2000.

As noted above, two audits have been performed on the Contractor relating to their Y2K expenditures with the following results:

ADJUSTED:	REGION V	REGION IV	DUPLICATE	FINAL
Personal Service/Fringe	($51,399)	($147,787)	$39,874	($159,312)
Duplicate Exp/Errors	($36,153)	($94,770)	$34,108	($96,815)
Contractual Services	($57,000)	($32,781)	$32,781	($57,000)
Depreciation Expense	($53,458)	($65,005)	$53,458	($65,005)
Exp Exceeding NOBA	0	($308,643)	0	($308,643)
Unreconciled Costs	0	($280,820)	0	($280,820)
Y2K Overbill	0	($273,123)	0	($273,123)
Salary/Fringe Oversta.	0	($198,304)	0	($198,304)
SUB - TOTAL	($198,010)	($1,401,233)	$160,221	($1,439,022)
SET - ASIDE:				
Not Reported on FACP	0	($50,913)	0	($50,913)
Non-Supported Costs	0	($2,567,586)	0	($2,567,586)
SUB - TOTAL	$0	($2,618,499)	$0	($2,618,499)
TOTAL	($198,010)	($4,019,732)	$160,221	($4,057,521)

After Removal of Duplications

Y2K Adjustments =	($1,439,022)
Y2K Set - Asides =	($2,618,499)

During the course of the FACP audit, Contractor management assured us that the Y2K audits had been negotiated and settled in full with CMS. When we spoke with CMS management, however, they knew of no such settlement.

The FACP audit covered the filed FACPs and related costs from October 1,1994 through September 30, 1998.

The Region V (audit (a)) covered Y2K costs as of September 30, 1998.

The Region IV (audit (b)) covered costs claimed from October 1998 through June 1999.

To settle the Y2K audits, we recommend that the Contractor repay $1,439,022 in order to reimburse the Government for those costs determined to be non-allowable in these two audits. Then, CMS should review the $2,618,499 of set-aside costs from these two audits in order to determine if all or part of those costs should be repaid to the Government from the Contractor. The CMS's determination on the $2,618,499 set-aside costs by Y2K auditors should also take into consideration the $1,856,266 adjusted by FACP auditors in Exception 26, which deals with undocumented costs. We requested documentation for this amount, which was labeled as "Y2K Adjustment," but no support was received.

CURTIS W. LORD
PRESIDENT
CHIEF EXECUTIVE OFFICER

August 17, 2001

Office of Inspector General
Charles Curtis, Regional Inspector General
Region IV, Room 3T41
61 Forsyth Street, S.W.
Atlanta, GA 30303-8909

Re: Draft Report (CIN) A-04-99-05561

Dear Mr. Curtis:

On behalf of Blue Cross and Blue Shield of Florida (BCBSFL) and First Coast Service Options, Inc. (FCSO)[1], I am forwarding our response to the Office of Inspector General's (OIG's) draft audit report, CIN A-04-99-05561. The response sets forth in detail our position, with appropriate supporting documentation, regarding the issues identified in the draft audit report. Moreover, the response provides a basis upon which those issues can be resolved in a timely manner.

We take very seriously our obligations as a Medicare contractor. Because the draft report questions the extent to which we have carried out certain of those obligations, we have prepared an extremely complete and thorough response. As our response outlines, we believe the vast majority of the findings cited in the draft report are without merit. To summarize, we agree with $708,943 of the amount cited as disallowances in the report, and disagree with $14,526,006 cited as potential disallowances. Additionally, in researching our response, we identified two cost allocation corrections which, when made, will increase claimed reimbursement for the period under audit by $1,707,735.

We recognize that during the audit, a sense of frustration and some delays were experienced by the OIG. Furthermore, we recognize that the OIG's perception is that our responsiveness during the audit was insufficient. While we do not agree with all the assertions in the Draft Report regarding our performance during the audit, particularly those in Appendix D (as our attached response reflects), we do recognize that we failed to perform to the level to which we seek to hold ourselves during government audits. Consequently, we have already begun a series of improvements to ensure that our ability to respond to audits in the future is significantly enhanced. Those improvements, which are summarized in the introduction to the response, include hiring

[1] FCSO, a wholly owned subsidiary of BCBSFL, administers the Medicare Part A and Part B contracts on behalf of BCBSFL.

personnel with experience in responding to government audits and improving record retention practices.

As you may know, Mike Davis and Pat Williams recently met with Wayne Griffin to discuss not only the draft audit report, but, more importantly, ways to ensure that our working relationship with the OIG is improved. FCSO's guiding principles are founded on "doing the right things, the right way." You have my commitment that moving forward these principles will be more evident in the OIG's dealings with FCSO. Furthermore, we believe that this response, and the related follow-on work, provide the basis for establishing a working relationship that will ensure both of our organizations perform their respective obligations efficiently and effectively.

Finally, we appreciate the opportunity to provide our response, including the due date extension, and look forward to further discussions to resolve these matters. Mike Davis will be contacting your office soon to arrange a meeting in the next few weeks to begin those discussions. In the interim, if you have any questions or believe there are other steps we need to take more quickly, please feel free to contact me at (904) 791-8090.

Sincerely,

Curtis W. Lord

CL/ch

Enclosures

cc: Michael Cascone, Jr. – (w/o Exhibits)
Wayne T. Griffin, Jr. – (w/o Exhibits)
Rose Crum-Johnson – (w/o Exhibits)
Dale Kendrick – (w/o Exhibits)
Bernard Rach

APPENDIX D

INTRODUCTION

Blue Cross Blue Shield of Florida's ("BCBSFL") response to Draft Audit Report CIN A-04-99-05561, (attached hereto as Tab 1 in Book 1) is set forth below. Attached is a table summarizing our positions. Out of a total of $14,177,568 in recommended disallowances, BCBSFL agrees with $708,943 of the recommended disallowances, or approximately .7% of the FY 1998 FACP. With respect to two of the draft findings (see 5.B.2 and 5.B.6), our concurrence with the OIG leads us to conclude that our FY 1998 FACP was understated by $622,830 and $1,084,905, respectively for the two findings. The net result of the Draft Audit is that the Medicare Program owes BCBSFL an additional $998,792. Additionally, BCBSFL believes that the Draft Report's set aside of $97.2 million, which is essentially an extrapolation of the draft disallowances, is not valid.

Prior to responding to specific findings, we wish to note some characteristics of the Draft Report that cause BCBSFL particular concern.

1. Inaccurate Data – As indicated in the body of the BCBSFL's responses, the Draft Report cites dollar amounts that often cannot be reconciled with our books of record. BCBSFL suspects that the Draft Report relied upon an unofficial compilation of data (see Response to draft Finding No. 2), that we advised not be used.

2. Overstated Disallowances – In some instances, such as draft finding No. 5, the Draft Report questions the method of allocating certain cost centers and

indicates a preference for one method over another. In most instances, the use of one method instead of another yields relatively small differences in the amounts allocated to Medicare. The two exceptions are reallocations where Medicare had been undercharged in FY 1998. While the choice of allocation methods is a matter for discussion, BCBSFL is troubled that the Draft Report recommends disallowance of an entire cost center.

3. **Duplicate Disallowances** – Parts of several draft findings, e.g., Nos. 1, 5, and 6, disallow the same costs. While it is of course a matter of prerogative to cite more than one reason for recommending the disallowance of a cost, cost should not be disallowed in an additive manner or the duplicated amounts extrapolated.

4. **Unused Data** – BCBSFL regrets that it was not consistently able to provide data as quickly as was expected. However, the Company[1] is disappointed that the Draft Report does not reflect data that were provided both during and after the on-site phase of the audit.

We have also provided a detailed response to draft Appendix D. BCBSFL submits that, based on its response, Appendix D should be deleted from any final report. Although the

[1] Since January 1, 1999 (and consequently during the audit), First Coast Service Options, Inc. (FCSO), a wholly owned subsidiary of Blue Cross Blue Shield of Florida, Inc. (BCBSFL), has administered the Medicare Part A and Part B contracts on behalf of BCBSFL under a Special Power of Attorney. During the period under audit, however, BCBSFL was the administrator. While both FCSO and BCBSFL were involved in preparing this response, we have denoted this response in terms of BCBSFL as the entity formally replying, since it is technically the contractor and it was the entity under audit. Thus, the term "the Company" refers to BCBSFL and should be so read.

Company vigorously disagrees with the assertions and submits they are not appropriate or justified, the Company nonetheless recognizes that it needs to make improvements to ensure its ability to respond to audits in the future is significantly enhanced. The Company has therefore taken the following steps to ensure more productive audits in the future:

- It has augmented its Medicare financial staff with more seasoned professionals;
- It initiated, in early 1999, a Cost Allocation Improvement Initiative to provide better and more rigorous procedures to its cost allocation determinations;
- It has implemented a new system for retaining digitized images of invoices on CD Roms;
- It will develop and implement a more organized approach to records retention access.

The development and maintenance of a constructive relationship with the HHS OIG is of critical importance to the Company. BCBSFL will endeavor to improve its processes to reduce the frustrations experienced by both the OIG audit team and the Company personnel tasked to support them. It is our hope and expectation that the OIG will be receptive to working with BCBSFL to build a relationship that will facilitate the work of both organizations.

Finally, we recognize that the OIG may need to address some of the findings via an on-site visit, or simply need additional information. We have identified a team of qualified,

knowledgeable people who are available to be dedicated to work with the OIG's auditors to respond to this need.

FINDING NO.	AUDIT FINDINGS	AGREE	DISAGREE
	Introduction		
1.A.	FACP Accruals	$ 130,000	$5,558,600
1.B.	Materials & Supplies		187,060
1.C.	Furniture and Non-EDP Equipment		40,542
1.D.	Payroll 'Y' Adjustments		3,843
1.E.	Professional Fees		1,168
1.F.	Furniture & Equipment		89,832
1.G.	Materials & Supplies		341,174
1.H.	Miscellaneous Costs		17,051
1.I.	Chargebacks		1,472,380
2.	Contractor's data did not support cost discrepancies		406,637
3.	Lobbying Costs		89,321
4.	Contractor claimed costs that had no benefit to the Medicare Program	136,118	261,460
5.	Contractor claimed indirect cost allocations contrary to the FAR	228,601	1,097,876
5.A	BCBSFL's Indirect Cost Allocation System Compliance With FAR		
5.B	Certain Cost Centers Allocated as "Support"		
	7. Cost Center 041 – Human Resource Integrators		
	8. Cost Center 289 – EDI Infrastructure		

FINDING NO.	AUDIT FINDINGS	AGREE	DISAGREE
	9. Cost Center 833 – Centers for Excellence; I/T Marketing		
	10. Cost Center 835 – Network Infrastructure		
	11. Cost Center 858 – Development Environmental Services		
	12. Cost Center 989 – Electronic Commerce		
5.C.	Misallocation of Internal Audit	89,339	
5.D.	Alleged Overstatement of Miscellaneous Finance Charges		668,694
5.E	Miscellaneous Costs	4,377	
6.	BCBSFL did not properly reverse accruals for indirect costs resulting in an overstatement		203,323
7.	BCBSFL claimed costs incurred and paid in another period		2,057,565
8.	BCBSFL claimed Executive Compensation in excess of statutory limits		677,342
9.	BCBSFL claimed travel costs in excess of Federal Travel Regulation Limits		33,624
10 - 13.	Auditors Set-Aside costs due to lack of supporting documentation and overstatement. ROI included.		
	Sub-total FY 95 – 98 FACP Audit Findings	**588,435**	**13,207,492**
14.	Y2K findings from previous reports. Duplicate expenses, excess over NOBA unreconciled costs and non-supported costs.	120,508 (estimated)	1,318,514
	Total FY 95 – 98 Audit Findings	**708,943**	**14,526,006**

DRAFT FINDING NO. 1 – FACP ACCRUALS, CHARGEBACKS, AND OTHER COSTS - $7,841,650

The Draft Report asserts that BCBSFL did not provide adequate support for $7,841,650 in cost claimed in FY 1998. The allegedly unsupported costs included (1) $5,688,600 in FACP accruals; (2) $680,670 in other costs; and (3) $1,472,380 in costs related to certain "charge-back" cost centers. For the reasons set forth below and with two minor exceptions, BCBSFL disagrees with this assertion.

Draft Finding No. 1.A – FACP Accruals of $5,688,600

The draft report asserts that BCBSFL officials did not provide any support for FACP accruals ($2,579,856 for Medicare A and $3,108744 for Medicare B). During the on-site review, the FACP and IER files -- over 50 IER/FACP books -- for the years under audit were available to the OIG audit team. These books contain all of the information needed to support these costs, and BCBSFL was ready and willing to help with locating specific documents. Although each accrual in question is separately addressed below, all but one involved Section 208 projects or Y2K expenditures that were accrued as FY 1998 expenses pursuant to CMS's guidance.

Draft Finding No. 1.A.1 – FACP Medicare A Accruals of $2,579,856

BCBSFL disagrees with this entire finding. This amount represents the difference between the first FACP filed on 12/30/98 and FACP #10 filed on 12/30/99. (See Book 1, Tab 1a.) The components of this difference are:

• Provider Audit & Reimbursement (PARD) §208 Projects	$ $700,000
• CMHC Claims Review	100,200
• Y2K	1,847,570
• ARU	5,563
• Learn to Surf	9,853
• Allocation Adjustments	(83,334)
Total	$2,579,856

Draft Finding No. 1.A.1.a – PARD § 208 Projects ($700,000)

CMS provided BCBSFL with FY 1998 § 208 funding to conduct two projects related to Provider Audit and Reimbursement activities (CMHC and ESRD) during FY 1999. Invoices totaling $704,971 were available to support the § 208 projects for PARD (See Book 1, Tab 1a-1). Section 208 of the Departments of Labor, Health and Human Services, and Education, and Related Agencies Appropriations Act of 1993 permits funds to be used for one-year contracts that are to be performed over the course of two fiscal years. This provision was broadened in 1994 by Section 1083 of the Federal Acquisition

Streamlining Act, Pub. L. 103.355, which contains a similar provision permitting contracts for several services to begin in one fiscal year and end in the subsequent fiscal year. Consistent with established practices for the treatment of § 208 funds, BCBSFL treated these as FY 1998 expenditures. If CMS were to direct a change in such practices, BCBSFL would willingly treat these as FY 1999 costs. Until such guidance is received, these expenditures will continue to be included in BCBSFL's FY 1998 FACP.

Draft Finding No. 1.A.1.b – CMHC § 208 Funding for $100,200

CMS provided BCBSFL with FY 1998 § 208 funding to conduct an independent review of 150 denied Community Mental Health claims each month in FY 1999. The reviews were performed to determine if beneficiaries met the partial hospitalization eligibility criterion and if the services provided were medically necessary. The Company once again provides the documentation to support the claimed costs. (See Book 2, Tab 1a-2.) Consistent with established practices for the treatment of § 208 funds, BCBSFL treated these as FY 1998 expenditures. If CMS were to direct a change in such practices, BCBSFL would of course be willing to treat these as FY 1999 costs.

Draft Finding No. 1.A.1.c – Medicare A Y2K Costs of $1,847,520

During FY 1999, CMS implemented the "Y2K reporting process" which required Medicare contractors to submit a "Y2K IER" for both Medicare A and Medicare B on a monthly basis. This "Y2K IER" was a separate reporting mechanism established to accommodate the Y2K initiative. Medicare contractors were still required to submit the regular IER for FY 1999, excluding Y2K costs.

The first Y2K IER, reporting expenditures against FY 1998 funding, was due to CMS on November 30, 1998 (See Book 2, Tab 1a-3 for CMS letter to Region IV-Budgeted contractors – FMB:BF). CMS instructed contractors to report all Y2K expenditures incurred in FY 1999 against the FY 1998 NOBA on the Y2K IER. For the FY 1998 FACP, CMS instructed contractors to report only the Y2K funds expended in FY 1998 for Y2K and to re-submit the FY 1998 FACP for FY 1999 Y2K costs until the FY 1998 funds were exhausted. Because the reporting requirement for FY 1998 came after the fact, FY 1998 expenses had to be analyzed and then separated into regular FACP costs and Y2K costs. CMS guidance on what it wanted to be reported in separate Y2K submissions evolved throughout FY 1999.

When reviewing the FY 1998 FACP for Medicare A, the auditors requested supporting documentation for a $1,847,570 adjustment recorded on the FACP #10 reconciliation for Y2K. Consistent with the guidelines, an adjustment was made to record FY 1999 Y2K costs on the FY 1998 FACP #10. A summary of Y2K costs reported on the FY 1998 FACP #10 is provided below:

Year Expenses Incurred	Amount Filed
FY 1998	$ 647,736
FY 1999	1,895,317
FY 2000	-
Total	$2,543,053

As shown in the chart above, the actual FY 1999 Y2K costs of $1,895,317 filed on FACP #10 exceeded the adjustment applied to the FY 1998 FACP #10 by $47,747, thus the FACP #10 adjustment was understated and claimed costs should be increased. The reason for this difference is likely a function of CMS's evolving guidance about what to designate as FY 1998 Y2K costs. As that guidance changed, it appears that additional costs were classified as Y2K related. The documentation to support Y2K costs claimed for FY 1998 and FY 1999 [FACP #10] is attached at Book 2, Tab 1a-3.

Draft Finding No. 1.A.1.d – ARU Section 208 Funding ($5,563)

This adjustment represents the amount of an invoice received and paid in March 1999 for the ARU enhancement project that CMS funded under FY 1998 Section 208 funding. Consistent with established practice, this was treated as a FY 1998 cost. If CMS were to direct a change in that practice, BCBSFL would of course reclassify this as a FY 1999 expenditure. Documentation to support this invoice was available in the FY 1998 FACP backup books and is provided again in Book 2, Tab 1a-4.

Draft Finding No. 1.A.1.e – Learn to Surf ($9,853)

CMS provided funding for postage related to a publication to inform beneficiaries about the opportunity to participate in the Operation Restore Trust (ORT) initiative "Learn to Surf." Documentation to support this cost was available for review during the on-site phase of the audit. See Book 2, Tab 1a-5 for the invoice and March 1, 1999 letter to Brenda Francisco approving this project.

Draft Finding No. 1.A.2 – FACP Medicare B Accruals of $3,108,744

The amount questioned in the Draft Report is comprised of the following elements:

• Cost center 372 – GTE FACP Adjustment	$100,000
• Cost center 396 – FACP Item 16	1,152,478
• Y2K	1,856,266
Total	3,108,744

BCBSFL agrees with the finding regarding cost center 372 and will reduce its FY 1998 FACP by $100,000. The Company disagrees with the other two draft findings.

Draft Finding No. 1.A.2.a Cost Center 396, FACP Adjustment 16 in the Amount of $1,152,478

CMS provided FY 1998 Section 208 funds for the IBM Call Center project. The FY 1998 FACP included expenses totaling $1,950,507 for this project (the Draft Report addresses the remainder of these expenses in draft finding no. 7).[2] As indicated previously with respect to § 208 funding, and also in our response to draft finding No. 7, the inclusion of these costs in the FY 1998 FACP was consistent with established CMS practice.

The final FACP for FY 1998 included expenses totaling $1,950,507 for the IBM Call Center project. The FACP adjustment 16 represents the difference between the amount paid through August 1999 and the invoices that were received in subsequent months, most of which were paid in September. Documentation supporting the accrual was available during the on-site phase of the audit. BCBSFL has since located virtually all of the invoices to support this adjustment, see Book 3, Tab 1a-6 and Book 4, Tab 1a-6, and is confident that the few that remain will also be found. It should be noted that a corresponding reduction of $1,950,507 was recorded on the FY 1999 IER to ensure that these costs were not accounted for twice. Thus, if CMS were to agree with this draft finding, then BCBSFL would be due reimbursement for these costs in FY 1999.

Draft Finding No. 1.A.2.b – Medicare B Y2K Costs of $1,856,266

As previously addressed under the response to the Draft Report's comments on FACP Medicare A accruals (see response to draft finding 1.A.1.c), this adjustment was made to the FY 1998 FACP #10 to include FY 1999 expenses for Y2K. A summary of Y2K costs reported on the FY 1998 FACP #10 is provided below:

Year Expenses Incurred	Amount Filed
FY 1998	$6,351,364
FY 1999[3]	1,779,736
FY 2000	-
Total	$8,131,100

As the chart shows, the actual FY 1999 Y2K costs of $1,779,736 filed on the FACP was less than the adjustment applied to the FY 1998 FACP #10 by $76,530. Claimed costs should therefore be reduced. The documentation to support Y2K costs claimed for FY 1998 and FY 1999 was filed with FACP #10 was available for review during the on-site phase of the audit. (See Book 2, Tab 1a-3.)

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2 The difference between the amount cited in the Draft Report and the amount reported in this response are the three invoices totaling $705,776 in Cost Center 396, Call Center, addressed in our response to draft finding no. 7, below.

3 The total costs incurred at the time of this filing were $4,172,022. However, because FY 1998 funding was not available to cover the entire amount, only $1,779,736 was reported against FY 1998 funding and the remaining $2,392,286 reported on the FY 1999 Y2K IER against FY 1999 funding.

DRAFT FINDING 1.B – OTHER UNSUPPORTED COSTS

The Draft Report questions as unsupported a group of various costs that it aptly designates as "Other." Although there are seven subfindings addressed in the Draft, two of them ("Materials & Supplies" and "Furniture and Non-EDP Equipment") appear twice, but for separate amounts. The five types of "Other" costs questioned in the Draft report are (1) Materials & Supplies ($187,600 and $341,174), (2) Furniture and Non-EDP Equipment ($40, 542 and $89,832), (3) Payroll "Y" Adjustments ($3,194.01), (4) Professional fees (1,168), and Miscellaneous ($17,051).

Draft Finding 1.B.1 – Materials & Supplies

The Draft Report asserts that BCBSFL officials did not provide any support for Materials and Supplies expenses totaling $187,060 and $341,174. BCBSFL cannot determine why the Draft Report separated these findings. Because both findings arise out of BCBSFL's inability to locate invoices during the on-site phase of the audit, this response combines them. The $187,060 amount relates to five invoices from two printing companies for services provided in support of printing Provider Education materials. These expenses were incurred in the Medicare Provider Education department and are allowable costs in accordance with FAR. The $341,174 amount represents charges from the Corporate Print

Shop and Copy Center. Invoices supporting both amounts have been located and are attached in Book 4, Tab 1b.

Draft Finding 1.B.2 – Furniture and Non-Data Processing Equipment

The draft report asserts that BCBSFL officials did not provide any support for Furniture and Non-EDP Equipment expenses totaling $40,542 and $89,832. As with the draft findings for Materials & Supplies, neither the Draft Report nor the audit workpapers explain why there are two separate findings for these costs. BCBSFL agrees that all supporting information was not available to the auditors, but disagrees that the costs cannot be supplied.

The OIG audit team requested documentation for the monthly depreciation expense entries for different cost centers and various months. These entries are automated through the PFAS1685 program, which is the fixed asset production job that tracks and records the monthly depreciation expenses for fixed assets. The job runs daily to update the system with daily additions, transfers, retirements, etc. At month end, the system control card is toggled so that the system calculates the monthly depreciation expense. The month end run becomes part of the General Ledger Transaction Summary (FAR320 report). This is incorporated into the general ledger and creates the fixed asset entries in the general ledger, which were a portion of the OIG's sample transactions for this

finding. A monthly expense ledger report (report 21 of the PFAS1685 program) is the detail of all assets on the system and their current status.

One other report in this process, the fixed asset listing by cost center, is normally generated and reviewed each month to check whether the fixed asset chargeback system is producing the expected results. Due to a miscommunication, these particular reports were not retained by BCBSFL. However, data from the month end-run of the PFAS1685 including the General Ledger Transaction Summary (FAR320) and the Expense Ledger (report 21) is retained on microfiche (although one month in FY 1998 is unaccountably missing), which essentially allows the Company to reconstruct a fixed asset listing by cost center.

Thus, BCBSFL has taken the information available on the General Ledger Transaction Summary for the period from October 1997 through September 1998 and created an Excel spreadsheet. An analysis of the depreciation expenses for these cost centers reflects some month-to-month fluctuations that reflect normal additions or reductions in assets. The monthly depreciation entries are consistent for these cost centers for the total year. (See Book 4, Tab 1f). BCBSFL can provide the OIG audit team with the PFAS fiche and copies of the June 2001 detail reports and a walk through of the PFAS program. The program tracks fixed assets and calculates depreciation expenses in an accurate and reliable manner and adequate controls are in place to ensure the correct expenses are being booked to the ledger. (See Book 4,Tab 1f). However, BCBSFL also recognizes an opportunity to strengthen its document retention procedures for audit purposes. BCBSFL

is revising the Standard Operating Procedures for Fixed Assets to ensure the detail is retained for the appropriate time period and in a usable media format (i.e., microfiche, microfilm or other long-term storage format). In May 2001, BCBSFL initiated a corporate-wide Records Retention Workgroup to help address the need for enhanced procedures.

The audit workpapers indicate that some or all of the basis for this draft finding were some checks that had not been located during the on-site phase of the audit. Accordingly, attached are copies of check #1244629 for $2,029.50 to Oram Distribution for cost center 593, FCSO Beneficiary Services. Check #1245159 for $5,868 has not as yet been found. Our search revealed one roll of microfilm ending at check #1245158 and the next roll starting at check #1245160, which leads us to conclude that this particular check was not microfilmed. The actual box of canceled checks has been requested from off-site storage to see if the check exists and simply was not microfilmed. Copies of check # 0001254040 for $92,759.70 payable to Lucent Technology and cash receipt #1000063 for $115,415.18 from Lucent Technology are attached. Both transactions were recorded against Cost Center 822, Telecommunications Hardware. Check #1326223 in the amount of $282,921.56 to Bell & Howell for cost center 902, FCSO Mail-Outgoing, is enclosed as requested by the auditors. Lastly, a copy of check # 1317561 has been requested and will be provided upon receipt. (See Book 4, Tab 1f.)

Draft Finding No. 1.B.3 – Payroll 'Y' Adjustments

The Draft Report states that BCBSFL did not provide any support for payroll adjustments totaling $3,843. For $3,194.01 of the $3,842.84 identified, documentation was in fact provided. See Book 4, Tab 1d. These amounts represented voided checks. The remaining amount of $725.44 is the result of "Y" adjustments. "Y" adjustments are manual adjustments to employees' earnings resulting from timesheet corrections that produce positive or negative amounts, depending upon the type of transaction.

BCBSFL was led to understand that the remaining amount of $725.44 would be deemed immaterial.

Draft Finding No. 1.B.4 – Professional Fees

The Draft Audit Report asserts that BCBSFL did not provide any support for professional fees totaling $1,168. We are now providing the support. This amount was charged to a direct Medicare Part A cost center (Provider Audit and Reimbursement) for temporary services used. A copy of the actual check payable to Kelly Services, Inc. is provided in Book 4, Tab 1e. The amount in question is an allowable charge and should be reimbursed by CMS.

Draft Finding No. 1.B.5 – Miscellaneous Costs

The Draft Report asserts that BCBSFL officials did not provide any support for Miscellaneous expenses totaling $17,051. Documentation to support $16,014.30 or 94% of these items is available in Book 5, Tab 1h.

DRAFT FINDING NO. 1.C – CHARGEBACKS

The Draft Report asserts that BCBSFL did not provide any support for Medicare B chargebacks ($1,472,380) related to: $158,829 in facilities and occupancy costs; $1,205,959 in EDP equipment costs; and $107,592 in telephone costs. While BCBSFL contests this finding, it does not know why the Draft Report labels these chargebacks as unsupported. BCBSFL provided ample support for these costs during the on-site phase of the audit. See Book 6, Tab 1, for EDP Chargeback Invoices and General Ledger Reconciliations for the requested months. Accordingly, until BCBSFL is advised specifically what support is deemed lacking, this response will describe the chargeback process and, through exhibits, provide examples of the available and, for the most part, previously provided supporting documentation.

BCBSFL utilizes resource chargebacks as a basis for charging the costs of EDP systems, building occupancy, and telephones to the cost centers that use the services. The basic concept of the chargeback system is to charge all costs associated with these services to the end user in order to reflect the causal and beneficial relationship of costs incurred to a

receiving or user cost center. Thus, the chargeback method equitably distributes costs to cost objectives based on the amount of computer resources used, the amount of square footage occupied, and the number of telephones used by cost center personnel. Attached are BCBSFL's Resource Cost Center Process Descriptions, Standard Cost Rates, and Chargeback Flow Diagram. Book 6, Tab 1a.

Each Service Center annually budgets for the resources needed to service the Company's user community. Standard rates are then established for individual units of usage (e.g., CPU time, pages printed, square feet occupied). Each month, the usage by cost center is tracked for each individual unit of usage. The standard rate is multiplied by the actual usage with the resulting amount charged to the user cost center. As the usage amount is charged to the user cost center as a debit amount, an offsetting credit is recorded in a chargeback cost center (three chargeback cost centers have been established to capture the offsetting credit for building occupancy, EDP, and telephone usage), thereby balancing the entry. The debits charged to users equal the credits charged to the respective chargeback cost centers.

Once the monthly debits and the offsetting credits have been recorded, the standard usage credits recorded in the chargeback cost centers are compared to the actual charges accumulated in the cost centers of the areas that provide the services (Service Centers) to determine if the standard rates in fact represent actual costs. Any difference between the standard rate usage credits in the chargeback cost center and the actual costs accumulated

in the Service Centers is called residual. The residual amount, if any, is calculated individually for each of the three chargeback cost centers. The residual amount can be positive or negative and must then be allocated to the user cost centers in order to appropriately allocate all Service Center costs incurred to the user cost centers. The residual amount is allocated each month to the user cost centers based on percent to total usage for each chargeback area separately. If the residual amount is positive and the user cost center receives a debit entry, the chargeback cost center receives a credit. If the residual is negative, the user cost center receives a credit and the chargeback cost center receives a debit. Thus, on a monthly basis, when this process is completed, the charges in the user cost centers equal the costs incurred in the Service Centers. The costs of the services in the Service Centers are therefore exactly offset by the credit in the chargeback cost centers.

The cost of the services, which now resides in the user cost center, is then allocated to products or lines of business from the user cost center. The allocation methodology for the recipient or user cost centers, including the chargeback costs, is determined under BCBSFL's Costs for Pricing (CFP) system based on the causal and beneficial relationship of the cost center to lines of business or products, such as Medicare A and Medicare B. If CMS chooses, as seemingly suggested in the Draft Audit, to disallow Service Center costs because it dislikes the chargeback method, then an alternative methodology would have to be used to distribute these costs to individual products

because they are unquestionably allowable under the FAR and BCBSFL's Medicare contracts.

Below is a brief summary of the process by which each of the questioned resource areas determines their respective chargebacks.

Building Occupancy Chargeback Process - The Facilities and Occupancy service centers are responsible for building engineering and maintenance, facilities, lease management, renovation, real estate, food services, and security services to the corporation. These costs are charged back to the end user based on unit costs per square footage. See Book 6, Tab 1b, for the FY 1998 monthly summary of BOC charges. The Building Occupancy processing steps are as follows:

1. The Facilities Division budgets on an annual basis for resources needed to service and maintain the building. Standard rates are established for chargeable space per workstation. This measurement is used for both owned and leased facilities. The CAD (Computer Aided Design) system process is used to capture rates and track end user square footage utilization per workstation. (See Book 6, Tab 1c, for budgeted rate calculation.)
2. Monthly actual costs are incurred in the Facilities service centers and then distributed to user cost centers based on building occupancy statistics. The Building Occupancy

Chargeback group center is based on the same statistic as that of the Facilities service centers.

3. Monthly, the Facilities Division provides Cost Accounting with an electronic listing by building and cost center of square footage standard utilization costs. Cost Accounting calculates a percent to total ratio of standard costs per building and end user cost center. This percentage is applied to the summary of actual building occupancy service center costs to determine actual costs per end user cost center.
4. Monthly journal entries (See Book 6, Tab 1d, for October 1997, December 1997, January 1998 and September 1998 journal entries) are prepared and captured on the "Unallocated Detail Report" as a debit (expense) to the end user cost centers and a credit to the Building Occupancy Chargeback group center.
5. Monthly, Cost Accounting verifies that the total Facilities service center costs and the building Occupancy group (credit) center are equal to one another. Adjustments are made as necessary.

EDP Equipment Chargeback Process - The EDP Equipment service centers are responsible for providing centralized data processing, teleprocessing, capacity planning, PC hardware, system maintenance, computer production control and mainframe processing services to the corporation. Costs are incurred to employ the necessary hardware and personnel resources for the development, maintenance, and processing of corporate business through automated systems while maximizing available

technologies/services at the lowest reasonable costs. These costs are distributed through the chargeback system to areas using EDP Equipment services based on volume of usage.

The summary steps for the EDP Chargebacks are:

1. Annually the Information Systems/Computer Operations (IS&O) prepares a budget for all resources (personnel and equipment) required to service the Corporation. Standard rates are established for each chargeable work unit (systems labor hour, CPU hour, Print page, etc.). See Book 6, Tab 1e, for CY97 and CY98 Chargeback Rates. The Komand system is used to capture these rates and charge them back to the end user. This system tracks end user cost center utilization and applies the standard rate per chargeable work unit to calculate end user total cost of services.
2. The Komand system generates monthly, an automatic journal entry to the general ledger by cost center for the total cost of services utilized based on standard rate calculations. This entry is captured on the "Unallocated Detail Report" as a debit (expense) to the Product Recipient cost center and a credit to the EDP chargeback group center. The description on the unallocated detail report will read "EDP Chargeback". The costs charged back to the Product Recipient are allocated based on the end user cost center allocation methods, which will vary from one cost center to another.
3. Monthly actual costs are incurred in the individual Service Centers (resource) and allocated based on allocated results of prior month Chargeback Account statistics.

The EDP chargeback group center (credit) allocations are based on the same statistics as the individual Service (debit) Centers.

4. Prior to the monthly allocations, the Cost For Pricing (CFP) system, calculates the "residual" to adjust Chargeback group (credit) center costs and the user (debit) center costs. The CFP system makes an automatic journal entry to the "Unallocated Detail (with residual) Report". This entry is not posted to general ledger, since the net result is zero.
5. On a monthly and/or quarterly basis, Cost Accounting verifies that the summary of the Service center costs and EDP Chargeback costs are equal to zero. This control also validates that net costs charged back to the end users are adjusted to actual costs for these services using general ledger cost account detail.

Telephone Chargeback Process: The Telecommunication Service centers are responsible for providing and maintaining telephone equipment and voice system capacities to the corporation. These costs are charged back to the end user based on local telephone equipment inventory and long distance telephone consumption. Standard costs are captured on the Telephone Management System. The system tracks local and long distance utilization consumption costs by cost center. This information is provided to Cost Accounting for monthly journal entry preparation. The telephone chargeback process follows the same basic concept as the other chargebacks. An entry is made to debit the end user cost centers and credit the Telephone Chargeback group center. (See Book 6, Tab 1f, for a copy of the cost center control sheet for cost center 381 –

Telephone Chargeback Credit.) Controls are in place to verify that Telephone service center cost and Chargeback cost are equal to zero. End user cost center adjustments are made as needed. See Book 6, Tab 1g, for the actual local and long distance telephone bill for March 1998, long distance chargeback reports for March 1998 and November 1997, and a local telephone adjustment journal entry for July 1998.

In summary, costs incurred for chargeback services are distributed to cost centers using a reasonable and appropriate basis. The chargeback system is adequately, if not optimally, supported by contemporaneous records.

Draft Finding No. 2

BCBSFL's data did not support cost discrepancies

The Draft Report alleges that BCBSFL did not support "discrepancies between total costs allocated to Medicare and its internal accounting records," resulting in an overstatement of $406,637. This finding appears to be based on a comparison of two data compilations or views, called cubes, applying Cost for Pricing ("CFP") allocations to the Company's basic accounting data. The cubes or views provide the ability to perform both formal compilations of cost for various reporting purposes, such as the FACP, but also for "what if" analyses. Because the Draft Report acknowledges that the Company advised that the data compilation at issue "was a developmental data set, not production, so it should not be used for financial reporting purposes," (Draft Report at p. 7), any finding based on that cube is not valid.

The Draft Report compared the CMS or HCFA "cube"[4] to the "Alloc" or "Cumulative Alloc" cube and concluded that there was a $406,637 overstatement in FACP costs for FY 1998. Early in the audit, the OIG had been given open access to PowerPlay, which included the "Cumulative Alloc" cube. It was not until April of 2000, near the end of the on-site period of the audit, that BCBSFL was advised the "Cumulative Alloc" cube was being used. As discussed in detail below, the Draft Report erroneously relied on the

[4] "Cube" is terminology from the PowerPlay report writing software used by the Company. PowerPlay organizes data info "dimensions" and uses the extension, ".mdc" or multidimensional cube, for the data files it compiles.

"Cumulative Alloc" cube and consequently asserted an invalid finding. Were the correct extract, containing total costs prior to allocation – the "Detail," "Allocated" or "HCFA" cubes compared, no discrepancy would have existed. See Book 5, Tabs 2.

The "Cumulative Alloc" cube was created as a step towards determining whether the Company's accounting system could accommodate the requirement in Cost Accounting Standard (CAS) 406 that a CAS-covered contractor use an accounting period of a full year. As both CMS and the OIG are aware, BCBSFL, along with virtually all other Medicare contractors, uses a one-month accounting period. Possible compliance with CAS 406 was an issue in 1997 because the Office of Personnel Management (OPM) had decided to impose CAS on its Federal Employee Health Benefits Program (FEHBP) experience rated carriers. Due to the vigorous objections from such carriers, OPM postponed the imposition of CAS. There has since been a legislative exemption from CAS for FEHBP contractors.

The "Cumulative Alloc" cube did not, however, accurately represent data based on an accounting period of one year. This is because it applied allocation ratios from December to the entire year's cost data. For example, BCBSFL's general and administrative costs centers typically allocate based on the ratio of administrative expenses, which is the broadest measure of business activity used by the Company. The ratio of Medicare administrative expenses to those of the entire Company is approximately 14 percent. A system that is based on an accounting period of a month

will inevitably exhibit slight month-to-month variations in such ratios. Indeed, as noted elsewhere in the Draft Report, the Company's commercial business experienced some growth in 1998, where as its Medicare business did not. The application of the December 1998 administrative expense ratio to the entire calendar year of data would, therefore, obviously yield a lower, albeit inaccurate, allocation to Medicare. For example, in a cost center where there was a function change during the year, the result of which is that the cost center no longer allocates to Medicare, using the December current line of business allocations in the "Cumulative Alloc" model would not produce an amount for Medicare. Such an approach would cause the "Cumulative Alloc" model to provide inaccurate figures. Other ratios might have a contrary effect, but a net difference of $475,744, or less than one-half a percent of Medicare costs, established what BCBSFL expected would be the case, that the use of a monthly accounting period does not yield materially different results than use of an annual accounting period.

In April of 2000, BCBSFL explained that the "Cumulative Alloc" cube should not be used for any official purposes. Although never deleted from the PowerPlay directory, this cube was not utilized by BCBSFL for anything other than the "what if" exercise described above. Indeed, the "Cumulative Alloc" cube contains only data from 1997-1999. No additional data has been added to the cube since that time.

The Draft Report also asserts that BCBSFL (1) advised that the "Cumulative Alloc" cube was the most accurate for the auditor's purposes; (2) recanted that explanation; and (3)

"overruled the suggestion" of BCBSFL staff to utilize a third data set. Contrary to this finding, BCBSFL never recommended the use of the "Cumulative Alloc" cube; therefore, BCBSFL had nothing to "recant." It would appear, instead, that this was an inference drawn from an e-mail from a BCBSFL programmer – not a cost accountant – who gratuitously speculated that the "Cumulative Alloc" cube was as good as any other cube. Finally, BCBSFL did not "overrule" the suggestion of using a third data set – the "Detail" cube – to validate the costs in the Medicare data set. If it had been asked to clarify which data set would serve as a proper comparison, or how to access the Detail cube, BCBSFL would certainly have complied.

Because this draft audit finding is in error and no overstatement of FACP costs exists, BCBSFL will not reduce its claim for reimbursement for FY 1998 by $406,637 and requests that this finding be withdrawn.

Draft Finding No. 3 – Lobbying Costs

Lobbying Costs - The Draft Audit Report indicated on page 8 that BCBSFL charged $89,321 in unallowable lobbying costs. While BCBSFL agrees, of course, that lobbying costs are unallowable, it has verified that its FY 1998 FACP did not include such costs.

Both cost center 082, Health Care Reform, and cost center 240, Public Policy contain unallowable lobbying activities. It is the Company's established policy and practice to segregate and not claim expressly unallowable costs like lobbying. It has created code 95 for the express purpose of accumulating and segregating such costs. Our records show that our FY 1998 FACPs contain no costs from cost centers 82 and 240.

Through our review of the audit workpapers, we did find that costs for lobbying were allocated to the Company's Non-Reimbursable lines of business in FY 1997, therefore, this cost was not included in the FACP. See Book 5, Tab 3. The Company regards these lobbying activities as ordinary and necessary business expenses that benefit the entirety of the Company's business, although not reimbursable by Medicare. Therefore, it allocates the costs to the non-reimbursable Medicare line of business. The Company's records show that this was, in fact, done. Thus, we request that this finding be deleted.

Draft Finding No. 4 –

BCBSFL claimed costs that had no benefit to the Medicare Program

The Draft Report alleges that BCBSFL claimed costs of $397,578 for expenses not benefiting the Medicare program. According to the Draft Report, these expenses fall into two distinct categories: (1) human resources support for a corporate re-engineering project known as Virtual Office ($136,118); and (2) general research ($261,460). BCBSFL agrees in part with the substance of the finding relating to the human resources support cost center. BCBSFL disagrees, however, with the finding relating to general research cost center, as well as the dollar amounts of the human resource charge.

BCBSFL has thus far been provided with three different sets of numbers for the costs allegedly incorrectly claimed. See Draft exception report, Exception Standard Report, and Draft Audit Report. Neither of the exception reports contains figures similar to those cited in the audit report. Furthermore, BCBSFL's own data indicate that all three sets of data are incorrect. BCBSFL seeks clarification regarding the origin of the dollar amounts cited in the Draft Audit Report for each cost center listed below, as well as that in the two exception reports.

Corporate Re-engineering (Virtual Office)

The Human Resources Business Transformation cost center (014) provides human resources support for the "Business Transformation Corporate Initiative," otherwise known as the "Virtual Office" or "VO." According to BCBSFL's records, in FY 1998, this cost center allocated a total of $21,128 to Medicare for October 1997 through January 1998. As noted above, the auditor's work papers contain a figure of $23,314, which is inconsistent with, but close to the amount reflected in BCBSFL's own records. The $136,118 figure cited in the Draft Report appears to refer to two fiscal years: 1997 and 1998. BCBSFL agrees that, beginning in February of 1998, cost center 014 should not have allocated to Medicare, although it disagrees with the amount cited in the Draft Report, but prior to that date, cost center 014 properly allocated to Medicare.

The VO project was and is intended solely to benefit the Company's commercial lines of business. It has accordingly coded VO cost centers so that they do not allocate to Medicare. At its inception, Cost Center 014 was not established to work on the VO project. Its focus changed over time to support the VO project. The cost center was originally set up to provide management and leadership of corporate Human Resource strategy and to work on special projects. Prior to February 1998, the cost center was called "HR Administration and Special Projects." See Book 5, Tab 4. At that point, the cost center should have been reexamined to determine whether its allocation should also

change. While this was not done, there is no basis in fact for the implicit assertion that the cost center's function changed before February of 1998.

In sum, the VO project was deemed not to benefit the Medicare business, but due to an error, an HR cost center, that began supporting VO exclusively starting in February of 1998, should not have allocated to Medicare. Therefore, BCBSFL agrees that, for eight months in FY 1998, the allocation should have been different and that, as a consequence, the FY 1998 FACP should be reduced by $14,085.

Research Cost Centers

Cost Center 075 – Corporate Research

The Corporate Research cost center searches for, collects, indexes, files, analyzes, distributes, routes, and announces information related to health care, business, health insurance, management and marketing. This cost center serves the information needs of BCBSFL management and professional staff. The information collected and analyzed by personnel charged to this cost center benefits the entire corporation by providing essential information for management decisions, strategic planning, and allocation of corporate resources. These are allowable and allocable "economic planning costs" within the purview of FAR 31.205-12. Because this cost center benefits the entire corporation, including the Medicare unit, BCBSFL disagrees with the auditor's finding that this cost

center does not benefit the Medicare program. Accordingly, the $96,623 ($88,100 according to the Draft Report) for this cost center was properly allocated to Medicare.

Cost Center 270 – Business Research

The Business Research cost center provides information regarding economic, socio-demographic, technological, and other external environment trends and issues potentially affecting management decisions. Information obtained by this cost center is utilized by the Company in making crucial management decisions. Pursuant to FAR 31.205-12, "economic planning costs," these costs are allowable and allocable. Therefore, BCBSFL disagrees with the draft finding that this cost center does not benefit Medicare. It is BCBSFL's view that $62,005 ($56,861 according to the Draft Report) for this Business Research cost center was properly allocated to Medicare.

Draft Finding No. 5

Contractor Claimed Indirect Cost Allocations Contrary to the FAR

The Draft Report questions a total of $2,088,887 for support centers, internal audit, miscellaneous finance, and miscellaneous costs allegedly allocated in a manner inconsistent with the FAR. Eleven different cost centers are at issue. The Draft Report states that four of them, cost centers 41, 208, 418, and 527, should not have allocated to Medicare. For the reasons set forth below, BCBSFL disagrees. For the remaining seven cost centers, 289, 833, 835, 858, 898, 615, and 699, the Draft Report asserts that the wrong allocation method was used, but questions the entire allocation rather than just the difference between the allocation methods. BCBSFL agrees with some, but not all, of the allocation changes suggested in the Draft Report.

The Draft Report also generally asserts that the design of BCBSFL's allocation system caused the alleged over-allocation of costs. With respect to several cost centers that were allocating as support, BCBSFL agrees that they should have been allocating administratively. These were not the result of flaws in the design of the Company's cost allocation system, but rather reflected incomplete information about the cost centers input into the system when it was redesigned in 1997.

Even where we agree in retrospect, the change in the method of allocation yields only minor downward adjustments (less than .1%) to the amounts charged to Medicare and

two large upward adjustments. The net effect of agreeing to these changes is an undercharge to Medicare.

The accuracy and reliability of the Company's cost allocation system are nonetheless matters of utmost importance not only for the Medicare LOB, but also to the entirety of its business. Accordingly, and quite independent of this audit, the Company observed that there was need for continuous improvement in the Cost Allocation System, and had initiated a comprehensive review of its cost allocations. A Cost Allocation Improvement Initiative was initiated in early 1999 with the objective of improving the allocation process. The initiative includes the following steps:

1. Requiring face-to-face interviews with the managers of all 800+ cost centers regarding their allocations. (This began in April 2001 and will be completed in November 2001.)
2. Designing an extensive questionnaire to ensure that all interviews are complete;
3. Requiring two reviews, rather than one, of all allocation changes;
4. Updating all cost center names to reflect more clearly their functions; and
5. Providing standard monthly reports of allocations by cost center.

What the draft audit report noted were some imperfections in the first generation of cost allocations that emerged from a redesign of the system in 1997, known as the "Cost For Pricing" or CFP allocation system. CFP was developed with several objectives in mind:

- Improve the accuracy and accessibility of accounting information regarding costs of the Company's various products and services; and
- Simplify the then existing cost allocation system, which was a variation on the Standard National Accounting Package (SNAP) developed by the Blue Cross Association in the 1950s.

While these were each worthy goals, the Company has since learned that, in limited situations there were inevitable pitfalls. In particular, the Company may have underestimated the elusiveness of the concept of "benefit" in cost accounting in the process of classifying a very small number of cost centers. Because an important distinguishing feature between an "administrative" and a "support" cost center is whether it "benefits" all lines of business or only some, respectively, a manager who has an extremely literal concept of benefit would tend to characterize his or her cost center as support in the discussion with the cost accounting analyst. Thus, with the advantage of hindsight and a more appropriate definition of cost accounting benefit, BCBSFL agrees with several of the draft audit report findings.

Additionally, BCBSFL's review of its records in response to this finding consistently yielded amounts that differ from those referenced in the Draft Report. BCBSFL analyzed

Medicare allocations from the HCFA cube and "detail" cube for FY 1998. (See Book 5, Tab 2.) Although BCBSFL's figures are sometimes close to those addressed in the Draft Report, the two sets of numbers invariably contain differences. BCBSFL requests that the OIG provide information for each of the cost centers regarding the sources of the data used in the Draft Report.

Draft Finding No. 5.A

BCBSFL's Indirect Cost Allocation System Compliance With FAR

The Draft Audit Report asserts that BCBSFL's allocation system does not comply with the FAR. The Report cites FAR 31.203(c), which states in part, "All items properly included in an indirect cost base should bear a *pro rata* share of indirect costs irrespective of their acceptance as Government contract costs." FAR 31.203(c) does not, however, prescribe the exact system that a contractor must employ to allocate such costs.

Each contractor may develop its own policies and procedures to allocate costs to the Medicare program so long as it does not violate the FAR. BCBSFL's system for allocation of support center costs, while not exactly as the OIG prefers, does not violate the FAR. This process is established, consistent, and uniformly applied to all support center cost allocations. Therefore, the Report's position is without merit.

BCBSFL's system for allocation of support cost centers was the result of a detailed analysis of allocation philosophies, and the application of an agreed upon approach that was approved by senior management, and, moreover, was reviewed with both CMS (HCFA at that time) and FEP oversight agencies. In 1996, we shared an analysis of the impact of the new system with CMS and received approval from FEP to implement the system and use it as our basis of billing these programs for our administrative costs. In

1995, Coopers and Lybrand was engaged to perform a due diligence review. The system was deemed sound from an allocation perspective.

In 1999, FEP conducted an audit of the allocation system (for FY 1998 and FY 1997) and found very few allocations issues. They were certainly not the magnitude indicated in this Draft Report. In addition, PricewaterhouseCoopers (PwC) has conducted an audit of administrative expenses for FY 1997 and FY 1999 for the FEP contract. The results of these audits produced no significant findings with respect to the allocation philosophies or practices of BCBSFL.

Draft Finding No. 5.B

Certain Cost Centers Allocated as "Support"

Draft Finding No. 5.B.1

Cost Center 041 – Human Resource – Integrators

The Draft Audit Report misstates the purpose of cost center 041 and, therefore, the finding is incorrect. The Human Resource – Integrators cost center assists with the integration of human resource strategy and organizational effectiveness improvement for corporate business units. During FY 1998, from October 1997 through January 1998, this cost center allocated administratively, which means that the cost center's costs are spread ratably over all lines of business (LOB). In February, BCBSFL changed the allocation to reflect the reorganization of the Human Resource – Integrators cost center to better serve specific lines of business. The change in the allocation process was therefore prompted by a legitimate change in the operation of BCBSFL's business.

Following the February 1998 reorganization of cost center 041, 50% of the cost center allocated as a support cost center across all lines of business. The remaining 50% of the cost center was allocated as operational support and excluded Medicare. This is because the reorganization entailed the addition of staff assigned to support non-Medicare operations. As a consequence, this change did not materially alter the monthly amounts

allocated to Medicare. See Book 5, Tab 5b-1. In fact, the percentage of allocations remained approximately 14% -- at 14.2% of total corporate allocations for FY 1998.

BCBSFL's records show a different amount from that quoted in the audit report. BCBSFL therefore requests that additional information be provided regarding this data source. Irrespective of the number, however, BCBSFL maintains that this cost center was correctly allocated and it will not reduce its FACP, and it requests the withdrawal of this finding.

Draft Finding No. 5.B.2

Cost Center 289 – EDI Infrastructure

This cost center tracks expenses associated with maintaining and operating the Company's gateway for electronic data interchange, (i.e., electronically filed claims). Volume statistics are provided on a monthly basis to maintain current allocation factors. Although this cost center more closely resembles an operational cost center, because its expenses are distributed based on EDI claims volumes, BCBSFL consistently has treated this as a support cost center.

BCBSFL admits that the percentage of electronically filed claims assigned to Medicare in FY 1998 was in error. This error was corrected in 1999. See Book 5, Tab 5b-2. In

fact, FY 1998's Medicare electronic claims volume was 84% and private business volume was 16%. If actual claims volume had been utilized to allocate these expenses, an additional $622,830 would have been allocated to Medicare in FY 1998. BCBSFL will therefore amend its FY 1998 FACP to reflect an upward adjustment of $622,830.

As discussed above, BCBSFL's numbers do not agree with those in the Draft Report. BCBSFL's erroneous FY 1998 allocations for this cost center were $261,834 of total corporate allocations of $1,053,172. BCBSFL therefore requests information regarding the OIG's data source.

Draft Finding No. 5.B.3

Cost Center 833 – Centers for Excellence; I/T Marketing

BCBSFL agrees with the Draft Report's finding that this cost center should be allocated on an administrative basis. This cost center currently supports the I/T department by communicating and promoting the Information Technology department's capabilities, products, and services to its in-house customers. It also enhances communication within and among the I/T consumer base, the Chief Information Officer's organization, business units, and senior management. Among these support functions is the assignment of an I/T integrator to First Coast Service Options, Inc. This cost center has been allocating administratively since April of 1999, when it was reorganized.

Prior to April of 1999, the cost center was responsible for the development of computer applications. Work was performed on a Company-wide basis and benefited the entire enterprise, including Medicare. While the cost center's activities were different from today's, it should, in retrospect, have allocated administratively prior to April of 1999 because all lines of business benefited. The net effect of adjusting this allocation is $60,209. See Book 5, Tab 5b-3.

The Draft Report's data do not mirror that of BCBSFL. CFP shows allocations to Medicare for FY 1998 as $129,001 (25.1% of total corporate allocations), while the Draft recites an amount of $126,628 (24.6% of corporate allocations). Therefore, BCBSFL requests information regarding the Draft Report's data source.

Draft Finding No. 5.B.4

Cost Center 835 – Network Infrastructure

The Network Infrastructure cost center tracks the corporation's network infrastructure and related equipment expenses such as rentals, depreciation, and equipment maintenance. Although the Draft Report asserts that these costs had been allocated as support, BCBSFL changed allocation methods during FY 1998. The cost center was allocated as support from October 1997 through February 1998. At the time it was called I/T Strategy Administration. Following a reorganization in March of 1998 the cost center name was changed to Network Infrastructure and was allocated as a resource cost center.

Under the resource allocation method, expenses are, in fact, allocated administratively with an offsetting credit for chargebacks in cost center 810. The chargebacks are for actual hardware use, including video conferencing, remote access, routers, sniffers, CAT 5000, controllers, channel extenders, bridges, modems, and servers. Actual chargebacks to the Medicare cost centers averaged 12.4% for the four months questioned in the Draft Report. Because the Draft Report incorrectly identifies this as a cost center that allocates as support, we assume there is no real dispute about allocation after February of 1998.

Prior to February of 1998, in addition to maintaining hardware equipment, the cost center supported the electronic claims processing system which was predominantly used by Medicare A & B. While these EDI functions were being performed, the cost center was appropriately allocating as support. In February 1998 when this activity was transferred to cost center 289, the balance of cost center 835 became a chargeback cost center as noted in the preceding paragraph.

Draft Finding No. 5.B.5

Cost Center 858 – Development Environmental Services

This cost center is responsible for the design, implementation and ongoing operation of the technical architecture services, distributed middleware solutions, and web environmental facilities in use for systems delivery for all lines of business. In addition,

the cost center designs, constructs and operates development and testing environments for specific engineering technology projects. This cost center allocated consistently in FY 1998 as support. Inasmuch as this cost center benefited all lines of business, BCBSFL agrees with the draft finding that this cost center should be allocated administratively. The net effect of adjusting the allocation is $94,351. Book 5, Tab 5b-5. There is, of course, no justification for disallowing the cost center in its entirety.

Additionally, as discussed above, BCBSFL's data does not match that of the Draft Report. CFP shows total allocations to Medicare for FY 1998 as $228,601, or 22.8% of total corporate allocations of $1,001,860, while the Draft Report indicates an allocation of $226,966, or 22.6% of the total corporate allocations of $1,002,116. BCBSFL requests that the OIG provide information regarding this data source.

Draft Finding No. 5.B.6

Cost Center 898 – Electronic Commerce

The electronic commerce cost center maintains and enhances electronic commerce systems used by both Medicare Parts A and B, private business, and Virtual Office in the receipt and transmission of claims between BCBSFL systems, Florida Shared System ("FSS") and GTE. In contrast to Cost Center 289, EDI Infrastructure, which is responsible for the gateway for receipt of electronic claims, cost center 898 is responsible for the hardware and software that distributes electronic claims to the appropriate claims

processing systems. For the first quarter of FY 1998, this cost center was allocated administratively at a rate of 12.7%. BCBSFL then determined that the cost center erroneously allocated to the FSS line of business, and the allocation was subsequently changed to support for January 1998 through September 1998 at a rate of 25.3%.

Upon review of this cost center's activities, BCBSFL has determined that its allocation as support, while an improvement over an administrative allocation, was still not optimal. A more accurate method would be to allocate this cost center based on a ratio of electronically filed claims. In FY 1998, 84% of all electronic claims were for Medicare; correspondingly, 84% of this cost center, or $1,084,905 should be charged to Medicare. Book 5, Tab5b-6. BCBSFL will amend its FACP accordingly.

Finally, as discussed above, BCBSFL's computations do not agree with those in the Draft Report. CFP shows total allocations to Medicare for FY 1998 as $371,443.47, or 21.4% of total corporate allocations of $1,733,748, while the Draft stated it was $366,978, or 21.2% of total corporate allocations of $1,734,692. BCBSFL seeks information regarding the OIG's data source.

Draft Finding No. 5.C - Misallocation of Internal Audit

BCBSFL both agrees and disagrees with the draft audit report's assertion regarding the allocation of internal audit expenses to Medicare. The draft report indicates that $89,339 in internal audit costs were over-allocated to Medicare. While BCBSFL was unable to verify this number, the Company agrees that these costs should have been allocated based on the administrative expense ratio used for G&A type expenses, and not allocated as a support cost center. The Company's records show that cost center 615 was allocated to Medicare at a 16.9% rate, whereas the OIG's workpapers show a 20.6% rate. Using the FY 1998 administrative rate, 13.4% of cost center 615 should have allocated to Medicare. The correct amount of allocation to Medicare in FY 1998 should therefore be $447,668, which is a reduction of $116,356. Book 5, Tab 5c.

With respect to Internal Audit's function in the Company, it should be obvious the department exists to fulfill a number of related corporate objectives. In this regard, internal audit

- is a critical element of responsible corporate citizenship;
- ensures compliance with a broad array of federal, state, contractual, and corporate requirements;
- determines the adequacy of internal controls; and
- assesses whether corporate resources are effectively and efficiently deployed.

An internal audit department is thus broadly charged with protecting the Company's assets, both monetary and its brand. It must also respond to a constantly shifting environment of risks. The focus of its audits will, therefore, change over time to mirror the Company's perceptions of where its greatest risks might be.

In effecting these corporate objectives, internal audit will focus on functions and activities that are both administrative in nature and housed in particular business units. It might audit petty cash and computer services, *i.e.*, administrative functions, or it might audit whether a particular business unit has processed its claims in a timely and accurate manner. In the latter case, the draft audit report appears to be asserting that internal audit should not be allocated to the business unit at issue.

Internal audit is first and foremost a department that serves overarching corporate purposes. In doing so, it will, more often than not, make recommendations to improve operations and controls for specific lines of business, but that is the result of, and not the cause for, their activities. The causal relationship between the internal audit function and particular lines of business is too removed to justify anything other than the Company's broadest allocation method, administrative.

With respect to the Draft Report's suggestion that internal audit's time records should be used for cost accounting, we disagree for several dispositive reasons. First, the

department's informal time records are used for its own budgeting and estimating purposes and they are not corporate accounting records. Second, while the Company has no reason to question their accuracy, it could not responsibly rely on them for cost accounting because they are informal. If these time records had been used for cost accounting purposes, the OIG very likely would recommend disallowing the internal audit cost center allocations because the time records exhibit none of the protocols associated with timekeeping for cost accounting (*e.g.*, time recorded daily, in ink, no whiteouts or erasures, initialed crossovers, employee and supervisory signatures, no post-submittal changes without employee approval, floor checks, etc.). The suggestion in the draft audit report is therefore unsupportable and should be withdrawn.

Draft Finding No. 5.D

Alleged Overstatement of Miscellaneous Finance Charges

The Draft Report asserts that BCBSFL overallocated $668,594 in miscellaneous finance charges in FY 1998 for cost center 699. This draft recommendation appears based on a simplistic view of cost center 699, the variety of costs that are charged to it, and the corresponding differences in allocation methods.

Cost center 699 is responsible for capturing a mix of costs that allocate in different ways. It includes vacation and holiday accruals, return on investment for real estate and equipment, and supplemental executive pension. In December of 1997, the cost center also was credited with the reversal of an accrual that was not allocable to Medicare and charged with a year-end adjustment to employee pension costs that reflected an under-accrual in the preceding 11 months. Each of these types of cost were, and should be, allocated using distinct methods. The Draft Report's suggestion that the costs should be lumped together (and netted against the credit) and allocated as an administrative expense fails to reflect the variety of costs in cost center 699.

Some of the costs – holiday and vacation accruals – are similar in nature. They allocate based on the ratio of administrative expenses, which the Draft Report agrees is appropriate. The pension year end adjustment, on the other hand, is allocated directly to lines of business based on the pension costs per individual employee. Because there is a

direct causal link between the cost, pension, and the cost center to which the individuals receiving the pension belong, a direct allocation is by far preferable to an administrative allocation.

Another component of cost center 699 is the return on investment in facilities and equipment, *i.e.*, the imputed cost of capital that is allowable under FAR 31.205-10, which allocates based on the ratio of tangible capital assets among BCBSFL businesses. Again, this is a more rigorous and appropriate allocation than an administrative expense ratio.

Lastly, the reversal of the reserve excluded Medicare because this reserve was for a legal matter that was not chargeable to Medicare in the first instance. The reserve was for United States ex rel Burr v. BCBSFL, Inc., Civ. A. No. 91-134-5-16 (M.D. FL), which was a Civil False Claims Act *qui tam* case. BCBSFL and GTE settled the case in 1993 without admitting liability. Nonetheless, the costs (and settlement amount) associated with the case were not allowable pursuant to FAR 31.205-47 (costs related to legal and other proceedings). The elimination of the reserve set up to cover this case was, therefore, not credited to Medicare and was allocated solely to the Company's commercial lines of business.

Based on the foregoing, it should be apparent that cost center 699 is comprised of diverse costs that require diverse allocations. The Draft Report's recommendations are,

therefore, inappropriate and provide no basis for an adjustment to the Company's FY 1998 FACP and should thus be deleted.

Draft Finding No. 5.E - Miscellaneous Costs

The Draft Report finds that BCBSFL claimed $4,377 in Medicare Part B reimbursement that related only to BCBSFL's private business, resulting in an overpayment. These costs include: (1) $1,355 in costs relating to the commercial HMO; (2) $1,036 in costs relating to the commercial business; and (3) $1,975 in costs relating to "PPC Care Manager subscribers." BCBSFL agrees with the Draft Report's assertion concerning these costs. BCBSFL implemented a process to identify and exclude these costs from future cost reports.

Draft Finding No. 6 – BCBSFL did not properly reverse accruals for indirect costs resulting in an overstatement

The Draft Report objects to BCBSFL's procedures for reversing accruals for certain indirect costs and asserts that this caused an overstatement of costs claimed of $203,323 ($52,602 for Medicare Part A and $150,721 for Medicare Part B). Specifically, the Report cited two cost centers: (1) the Management Incentive Program; and (2) Internal Audit. According to the auditor, BCBSFL's procedures resulted in an inaccurate reversal by not "tak[ing] into account variances in allocation rates between the time of the original transaction and the time of the reversal or correction," (Draft Audit Report on p. 14.) BCBSFL disagrees with this assessment.

Like most health insurance companies, BCBSFL's accounting system allocates all costs each month using that month's basis data, *i.e.*, the Company utilizes a monthly cost accounting period. Corrections are made, either to correct an inaccurate estimate or an error, according to the basis data at the time of the correction – *i.e.*, allowances are not made for the variances in allocation rates between the time of the original transaction and the time of the reversal or correction.

The auditor correctly noted that the Medicare allocation rate for the Management Incentive Program cost center was higher in 1997 than in February 1998 when the reversal was made. Allocation rates can and do vary month to month as the Corporate

recipient pool changes, but the variations are random over the long haul. Thus, from the health insurance industry's perspective, the use of a monthly cost accounting period is not materially distortive. The FAR states, in this regard, that an accounting period of a fiscal year will "normally" be used, but that "a shorter period may be appropriate . . . when it is general practice in the industry to use a shorter period." FAR 31.203(e). Therefore, BCBSFL disagrees with the finding regarding this cost center.

The Draft Report next questions the reversal of an erroneous allocation to Medicare for the Internal Audit cost center (615). The expenses at issue relate to consulting services of PricewaterhouseCoopers, the Company's external auditor, which should not have allocated to Medicare. The Draft Report asserts that these costs were never fully reversed to correct the erroneous allocation. BCBSFL properly reversed these charges in their entirety and no modification in allocation methodology is warranted.

BCBSFL reversed the majority of the improperly allocated charges of the Internal Audit cost center (615) during the month in which the costs were initially charged. See Book 5, Tab 6a. Due to a clerical error, however, one charge of $480,000 was not immediately reversed. Upon discovering this error, BCBSFL reversed this allocation in the FACP report in the period in which the reversal was made. See Book 5, Tab 6b. Therefore, BCBSFL, contrary to the Draft Report's statement, did reverse the entire original allocation.

As discussed in detail above, BCBSFL utilizes a monthly accounting period. Allocation rates can vary from month to month. Because such an accounting period is applied consistently, is the norm in the industry, and is compliant with FAR, no change in methodology is warranted. Therefore, no modification to BCBSFL's allocation methodology or to the amount claimed in the FACP is warranted.

As discussed in responses to other findings in the Draft Report, BCBSFL was unable to duplicate from its records the amounts placed at issue by the auditor. BCBSFL requests that the OIG provide information regarding its data source.

Draft Finding No. 7 – BCBSFL claimed costs incurred and paid in another period

The Draft Report found that in FY 1998, BCBSFL claimed $2,957,565 in costs incurred and paid in FY 1999. As a result, the Draft Report asserts an overstatement for FY 1998. The costs at issue include payments for information systems ($1,304,989), provider education ($46,800) and cost center 396 – Call Center ($705,776). The Report concluded that these costs should not have been included in FY 1998's costs, and instead belonged in the FY 1999 FACP.

Under FAR 31.201-1, BCBSFL can utilize "any generally accepted method of determining or estimating costs that is equitable and is consistently applied" when establishing its accounting methods. BCBSFL uses the accrual basis of accounting to determine the amount of cost to be assigned to cost accounting periods. Certain types of funding, however, complicate this seemingly straightforward process.

Section 208 of the Departments of Labor, Health and Human Services, and Education, and Related Agencies Appropriations Act of 1993 permits funds to be used for one-year contracts that are to be performed over the course of two fiscal years. This provision was broadened in 1994 by Section 1073 of the Federal Acquisition Streamlining Act, Pub. L. 103.355, which contains a similar provision permitting contracts for severable services to begin in one fiscal year and end in the subsequent fiscal year.

CMS approved several Section 208 projects for Medicare Part B for FY 1998. The approved amount totaled $2,308,000. See letter dated October 9, 1998, from Virginia Adams, CMS Regional Office to Brenda Francisco (Book 5, Tab 7) In addition, CMS funded a portion of FY 1999's Y2K expenses from FY 1998 funds. Each of the costs questioned by the auditor is addressed individually.

First, the Draft Report questions costs related to GTE Y2K tasks. BCBSFL disagrees with the auditor's assertion that this cost was incurred and paid in FY 1999. These costs include $207,432.50 for Y2K Millennium Compliance Testing, $417,512.46 for Y2K S&P and Computer Usage, and $680,044 for Hardware Component – Millennium Compliance, for a total cost of $1,304,989. The services rendered under this project were provided in FY 1998, in preparation for Y2K. GTE, however, simply did not bill BCBSFL until November 5, 1998. See GTE invoice, Book 5, Tab 7a. Because these costs were incurred for services rendered in FY 1998, BCBSFL disagrees with this finding and asserts that these costs were properly accrued in FY 1998 and, therefore, were allowable and chargeable under its FY 1998.

Second, the Draft Report questions $46,800 for costs incurred relating to the National Provider Education & Training Project. (See Book 5, Tab 7b.) This cost represents a pre-payment for services to be rendered in FY 1999, which was paid in FY 1998. These costs were correctly treated as FY 1998 expenses because BCBSFL incurred the

obligation in FY 1998 to fill an existing need for enhanced provider education publications. This alone is sufficient to justify accruing these costs in FY 1998. The mere fact that performance occurred in FY 1999 does not alter the fact that the costs must be accrued because the Company incurred an obligation for a certain sum in a prior fiscal year. Nor does prepayment alter this equation; it simply secured BCBSFL's place in the queue for obtaining these services. If CMS were to agree with this draft finding, however, BCBSFL would of course be willing to accommodate CMS. It is of little consequence to BCBSFL if these costs were reimbursed in FY 1998 or in FY 1999.

Finally, the Draft Report found that $705,775 relating to cost center 396 – Call Center was incurred in FY 1998, but paid in FY 1999. This amount represents FY 1998 Section 208 funding for services to be performed in FY 1999, and involved three payments: (1) $95,782.50; (2) $209,992.50; and (3) $400,000. (See Book 5, Tab 7c.). BCBSFL properly treated this as Section 208 funding, and disagrees with the Draft Report's finding that these costs were claimed in the improper fiscal year. Therefore, BCBSFL will not reduce its claim as requested in the Draft Report. Again, if CMS were to agree with this draft finding, BCBSFL would, of course, accommodate CMS and accept reimbursement in FY 1999.

Draft Finding No. 8 – BCBSFL claimed Executive Compensation in excess of statutory limits

The Draft Report questions $460,934 and $216,408 for FYs 1997 and 1998, respectively, for a total of $677,342 for executive compensation costs in excess of statutory ceilings. The auditor relies on Section 809 of Public Law 104-201, which allegedly applies a $250,000 ceiling for executive compensation for FY 1997 contracts, and on Section 808, Public Law 105-85, which sought to impose a permanent ceiling on contracts for FYs 1998 and beyond.

Both of the foregoing statutes, as well as their implementing regulations, purported to apply to contracts that were already in existence at the time the laws were enacted. The United States Court of Federal Claims has ruled, however, that such statutory limits on cost allowability can only be given prospective effort. In General Dynamics Corp. v. United States, No. 99-45C and 99-865C, 2000 WL 1337142 (Ct. Fed. Cl. September 15, 2000), the court ruled that the government was in breach of contract when it attempted to apply the Public Law 105-85 ceiling to contracts in existence prior to the issuance of regulation implementing the statute. The court relied on the standard "Allowable Cost and Payment" clause of the FAR, which explicitly referenced the FAR Part 31 cost principles "in effect on the date of this contract."

The fact that BCBSFL's Medicare Part A and Part B contracts do not contain the Allowable Cost and Payment clause does not place them outside the rule of the General Dynamics case. The Company's carrier and fiscal intermediary contracts both contain explicit language identifying the applicable FAR Part 31 cost principles. Appendix B to the Company's Medicare Parts A and B contracts states specifically:

> The term "Federal Acquisition Regulation (FAR)," as used in this Appendix B, means Part 31 of the FAR, Title 48, Chapter 1 of the Code of Federal Regulations, to which reference is made hereinafter, as in effect on the effective date of this agreement/contract and as it may be modified on or before each June 15 thereafter for any renewal period. [emphasis added]

Thus, only those cost principles in affect on June 15, 1996 apply to the FY 1997 contracts. The cost principles as of June 15, 1997 govern the FY 1998 contracts. In contrast, the regulation implementing this statutory ceiling of $250,000 on executive compensation was not issued until January 2, 1997 (61 Fed. Reg. 269), well after the October 1, 1996 effective date of the FY 1997 contracts. The regulations amended FAR § 31.205-6(p) to state:

> For contracts awarded during fiscal year 1997, costs incurred from October 1, 1996 through September 30,

1997, for compensation of an officer in a senior management position that exceeds $250,000 per year are unallowable.

FAR § 31.205-6(p) was amended again on February 13, 1998, to implement the Public Law 105-85 ceiling (63 Fed. Reg. 2981). Obviously, this regulation was promulgated too late to apply to the FY 1998 Medicare contracts, which were effective on October 1, 1997.

Thus, neither regulation was in effect on June 15 of the years in which the FYs 1997 and 1998 contracts were executed. Any attempt to apply the FY 1997 and FY 1998 ceilings to the Company's FY 1997 and FY 1998 Medicare contracts would therefore contravene an express term of the contracts. Any attempt to disallow costs based on those ceilings would, in turn, constitute a breach of contract.

Draft Finding No. 9 - BCBSFL claimed travel costs in excess of Federal Travel Regulation Limits

BCBSFL disagrees with the Draft Audit's recommended disallowance of $33,624 in travel costs for FY 1998. The Draft's methodology for decrementing the travel expense charges to allowed per diem rates is flawed. As discussed below, BCBSFL utilizes a multi-staged sampling methodology that contains a sufficient sample size that is randomly drawn. This methodology produces reliable results in a cost efficient manner. In contrast, the methodology suggested in the Draft Audit relied on a smaller, statistically invalid sample that inevitably yields distorted results. Moreover, while some of the Draft Report's criticisms of BCBSFL's methodology point out how theoretical improvements to the methodology could be made, they do not justify its abandonment.

The Draft Report's Methodology

The Draft Report's proposed methodology is flawed in two respects. First, it relied on an inadequate and unrepresentative sample for determining the difference, or "error rate," between government per diem rates and actual travel expenses. Second, a substantial portion of that smaller and less reliable sample are from cost centers that are either adjusted by BCBSFL for unallowable travel or do not allocate travel costs to Medicare and are, therefore, inappropriate for inclusion in any sample.

The sampling method suggested in the Draft Report focused exclusively on cost centers outside of Medicare. However, because 79% of all travel charged to BCBSFL's Medicare contracts come from Medicare cost centers, it is an inherently unrepresentative sample. In effect, the Draft Report picked its sample from a basket of "apples" in order to develop a factor for unallowable "oranges." Such a sample is not representative and would unavoidably yield distorted results.

Moreover, in restricting its focus to the remaining 21% of travel charged to Medicare, the sample used in the Draft Report included cost centers with travel costs that are either reduced before any allocation to, and per diem adjustments for, Medicare or simply not allocated to Medicare. Two such cost centers, Board of Directors (cc12), and Aviation Section (cc970), account for a third – 32% – of the costs included in the limited and unrepresentative sample advanced in the Draft Report. This further reduces the reliability of the sampling method set forth in the Draft Audit.

The reasons these cost centers should be excluded from any sample are, as follows:

- Board of Directors (cc12) – The Draft Report referenced CMS's FY 1991 – 1994 FACP Risk Assessment's recommendation that "the contractor implement procedures to ensure that guest travel expenses of the executive staff are not charged to Medicare." The Board of Directors cost center travel costs have since been reviewed each year and any items for guest travel have been removed from

claimed costs with a manual adjustment. By reinserting these costs into its sample, the Draft Report's methodology overstates the ratio of costs in excess of per diem.

- Aviation Section (cc970) – The Aviation Section cost center also is a chargeback cost center. It includes the costs related to the corporate airplane, maintenance, and pilot. The cost of utilizing the corporate airplane is charged back to the user area at the business traveler or coach airfare rate. A credit offset is placed in this cost center as the user cost centers are charged. The considerable residual costs remaining in this cost center are removed from the FACP as unallowable.

The above cost centers represent 32% of the sample pulled in the Draft Report's approach; in turn, the Draft Report's sample came from only 21% of the travel costs. The exclusion of these cost centers reduces the Draft Report's sample to a mere 14% (21% X 68%) of travel charged to Medicare. Therefore, the Draft Report's sample is statistically invalid.

BCBSFL's Sampling Method

BCBSFL's system for charging travel expenses is, in contrast, sound and cost efficient. BCBSFL utilizes a methodology established ten years ago for administrative expense reporting. This methodology was designed to ensure that only allowable travel is

charged. CMS reviewed this methodology during the FACP Risk Assessment for the period FY 1991 – 1994, and made no material findings. The OIG also reviewed this methodology for the FISS contract audit and made no findings. These governmental approvals, in addition to the safeguards addressed below, demonstrate that no change in the reporting methodology is warranted.

BCBSFL's sampling methodology is appropriate. The overwhelming majority of BCBSFL's travel for FY 1998 (79%) originated from the Government Program Division (Medicare). Upon verifying that this amount is consistent with other years, the Company reviewed a sample of travel expenses from within the division and extrapolated the overage percentage to both directly and indirectly charged travel expenses.

BCBSFL uses a multi-staged sampling methodology for its annual travel adjustment. First, a stratified random sampling methodology (also called proportional or quota random sampling) is utilized. This method divides the total population of divisional travel into non-overlapping subgroups, which in this case are Director areas. BCBSFL defines the sample unit to be one travel reimbursement check, and the sample size to be fifty checks. Because individuals may include multiple trips on a single expense report and frequently multiple expense reports are paid on a single check, BCBSFL generally samples more than fifty trips utilizing this methodology.

Within each subgroup, BCBSFL employs a systematic random sampling method. BCBSFL determines the number of checks needed from each Director area based on the proportion of travel dollars each area has to the total travel for BCBSFL during the previous fiscal year. BCBSFL numbers the checks in the total population, utilizing the unallocated detail as its source document for each Director area from 1 to *n*. The total population for each Director area is divided by the sample size for that Director to determine the interval. BCBSFL begins with the first travel check and selects checks at the interval until the end of that Director area is reached. The number of checks should equal the sample size that was predetermined for that Director. This method is repeated for each subgroup or Director area.

BCBSFL's methodology for determining the "the ratio of meal, lodging, and incidental costs to total travel costs for the Government Program Division" includes both divisional (Government Programs/Medicare) and non-divisional (the rest of BCBSFL) travel. The Company's methodology assumes that the ratio of meal, lodging, and incidental costs for the entire corporation represents the ratio of these expenses for allocated Medicare expenses. See Book 5, Tab 9. Total travel expenses include several other expense items (*i.e.*, car rental, air fares) in addition to the ones in question. Because the desired level of detail is available only at the corporate level, BCBSFL utilizes a ratio to determine what part of the total Medicare travel expenses are related to meal, lodging, and incidental expenses. An overage amount for all travel, divisional and non-divisional, is determined after an error rate, representing the percentage of overcharges from the sample, is

calculated. As stated previously, the overwhelming majority of the travel allocated to Medicare is divisional travel; the results from the majority are then used to determine the overage for the whole.

As noted in the Draft Report, BCBSFL utilizes a summary listing of government per diem rates provided by its Part A prime contractor, presumably with CMS's approval or acquiescence. Book 5, Tab 9. This list of cities contains varying per diem rates for the most frequently visited cities within each state. For example, the state of Florida is divided into three general areas, Miami, Orlando, and Jacksonville. The per diem rates for these areas varies, but closely approximate the per diem rates in the FTR list for geographically contiguous areas.

The regionalized list provides a cost-effective method for the processing of travel expenses. The difference between utilizing the list of 27 localities and the regional list is minimal and likely favors the government. The process of applying FTR per diems is tedious and time-consuming. The administrative burden associated with using the more detailed listing would very likely outweigh the travel costs that would be excluded from FACPs. BCBSFL would be willing to use the detailed listing, but emphasizes that the increased administrative cost burden that will be incurred to do so will very likely outweigh any inaccuracies in the current process.

The regional approach used by BCBSFL also likely overdisallows costs. First, the use of Miami, Orlando, and Jacksonville per diem rates captures the overwhelming majority of travel within Florida. These are the largest centers of population in the state, and are the most likely venues for travel to providers, conferences, and the like. The remaining 24 rates are for small cities and rural areas. While the per diem rates are lower, it is correspondingly easier to stay within per diems in such areas and, in some cases, it would even be difficult to exceed per diems. Thus, incorporating them into the Company's methodology is not likely to enlarge the "error rate," that is, the percentage by which actual meals, lodging, and incidentals exceed FTR per diems.

BCBSFL disagrees with the recommendation that it modify its sampling procedures and allocation methodology. The cost of implementing new procedures would likely outweigh the total amount of unallowable travel calculated each year. Moreover, BCBSFL notes that the FAR Council has proposed a regulation to eliminate per diems altogether. The travel overage calculation employed by BCBSFL ensures that appropriate charges are billed to the government and it does so in a cost efficient and economical manner. For these reasons, BCBSFL rejects the draft finding that travel costs were overcharged to the government.

Draft Finding No. 10-13 - Set-Asides

The Draft Report asserts that $99,837,242 should be set aside. This amount was developed based upon the $15,234,949 identified as FY 1998 findings extrapolated over the entire period of review (FY 1995 to FY 1998). As addressed in BCBSFL's responses to each assertion, BCBSFL does not agree with the majority of FY 1998 findings and has provided documentation to support its position. Therefore, set aside amounts should be removed from the report. Even where BCBSFL agrees, the government has not presented evidence that the issues existed.

Draft Finding No. 10-13 - Auditors Set-Aside costs due to lack of supporting documentation and overstatement. ROI included. FY 1995 to FY 1998

The amount set aside includes $7,137,670 of Return on Investment (ROI) claimed for the period under review. Based on discussions with the audit team, the auditors agreed that Return on Investment is allowable. However, they were questioning the level of reimbursement claimed. Hence, a summary of the process for determining reimbursement for ROI is presented.

The Draft Report states that requested documentation to support $1,228,398 of claimed costs for FY 1998 was not received. Based on this condition, they estimated that the total unsupported cost for this category for FYs 1995 through 1998 would amount to $7,137,670

Appendix B of the Medicare contract states:

> A. To the extent that land and tangible depreciable assets, such as buildings, equipment and leasehold improvements, owned by the Contractor are used for Medicare purposes, the cost of investment will be determined by multiplying the average undepreciated balance of such assets for the contract period by the actual rate of return of Contractor's investment portfolio for the contract period, or a lower rate if Contractor so chooses.

Return on Investment is recorded on a monthly basis at the Federal Treasury Rate of Return in the Miscellaneous Finance cost center 699. Consistent with the Medicare contract, BCBSFL adjusts the amount recorded on the FACP to reflect the actual investment rate of return.

Documentation to support the rate of return used by BCBSFL to adjust the system amount is retained in the monthly Interim Expenditure Report (IER) files. The journal entries prepared by Corporate Finance to record the ROI calculation (book value of buildings and equipment multiplied by the treasury rate) are retained by Corporate Finance and are available for review. We have included a sample of our monthly process for determining the Return on Investment (Book 5, Tab 10). Based on this additional information and the terms of the Medicare contract, we request the deletion of this assertion.

Draft Finding No. 14

Y2K findings from previous reports. Duplicate expenses, excess over NOBA, unreconciled costs and non-supported costs.

The Draft Report suggests that since no settlement of the Y2K audit had been made, that BCBSFL should refund $1,439,022 to CMS and set aside $2,618,499 to determine if costs were reimbursable and if they were properly stated. The Draft Report also asserts that the OIG followed-up with CMS Regional Office officials and asked what had been done concerning the collection of these costs. CMS officials were unaware of any refunds made by BCBSFL through any of its FACP filings concerning the findings of either of the two Y2K audits. BCBSFL disagrees with this finding.

On November 5, 1999 a letter was sent to Brian Crowe, CMS Regional Office, from Brenda Francisco, Manager, BCBSFL Finance, (See Book 5, Tab 14) communicating that BCBSFL had recalculated Y2K costs for the entire FY 1999 period incorporating the mutually agreed upon items. The recalculation of the Y2K costs was completed after the submission of the September, 1999 Y2K IER was prepared and submitted to CMS. Based upon this communication, BCBSFL informed CMS of its agreement or disagreement with the audit findings (CMS did not request any additional information) and settlement had been made for the items upon which we mutually agreed. These

assertions also appear to be duplicative of $3.6 million of Y2K related costs also cited in Finding #1 (Medicare A - $1.8 million; Medicare B - $1.8 million).

With respect to the FY 1999 Y2K audit report that was based on October – June, 1999 filed costs, BCBSFL reduced the administrative costs recorded on the IER for the following specific adjustments included in the OIG audit report with which it agreed. Based on the audit results, BCBSFL took appropriate action to address recurring and significant issues in a timely manner by adjusting the administrative costs reported on its FY 1999 IER as follows:

- $94,770 of duplicate charges for computer equipment. This amount was adjusted from the costs reported from October 1998 to September 1999.
- $759,010 of duplicate charges for Y2K costs billed to the Shared Processing User Group (SPUG), who are customers of BCBSFL for the period of October 1998 through June 1999. This amount, in addition to duplicate charges of $296,531 for the period of July 1999 through September 1999, was adjusted from the costs reported from October 1998 to September 1999. It should be noted that the OIG audit report included $273,123 of duplicate charges for Y2K costs billed to the SPUG. Therefore, BCBSFL reduced the administrative costs over and above the $273,123 of duplicate charges noted in the OIG audit report.
- $308,643 of Part B expenses reported in excess of the Notice of Budget Approval (NOBA) amount. This amount was adjusted from the 1998 IER and reported

against 1999 funding based on CMS's directive for the 1998 IER submitted on November 1, 1999.

- $280,820 of costs reported on the IER that were not supported by the accounting records. The 1998 IER costs were revised and submitted on November 1, 1999. The 1998 IER submitted on November 1, 1999 is supported by the accounting records.
- $50,913 of costs on the books that were not reported on the IER. The 1998 IER costs were revised and submitted on November 1, 1999. The 1998 IER submitted on November 1, 1999 is supported by the accounting records and represents costs on the books that relate to Y2K.
- $2,567,586 in unsupported expenditures reported on the December 1998 IER, applicable to the prior fiscal year. The 1998 IER costs were revised and submitted on November 1, 1999. The 1998 IER submitted on November 1, 1999 is supported by the accounting records and represents costs on the books that relate to Y2K.
- $198,304 of salaries and fringe benefit costs for employees' time that was charged to the Y2K project when they did not work on the project. The 1998 IER costs were revised and submitted on November 1, 1999. The 1998 IER submitted on November 1, 1999 is supported by the accounting records and represents costs on the books that relate to Y2K. These records include Y2K timesheets for actual hours worked. Additionally, supervisors who were not 100% dedicated to the Y2K project were removed from the costs included on the IER.

It should be noted that BCBSFL did not agree with the following specific adjustments included in the OIG audit report. As such, we did not make an adjustment for these recommendations:

- $147,787 of subcontractor fees for consultants used to replace BCBSFL Y2K employees. Based on CMS directives to realize incremental staffing costs in the form of overtime for their staff or by hiring additional personnel, BCBSFL reported the incremental compensation costs of the replacement personnel since these amounts would not have been incurred had the Y2K activities not been added to our workload. Additionally, on our August 31, 1999 submission in the remarks section we state that incremental costs are included. It should also be noted that it is common practice to charge only the incremental costs to the Productivity Investment ("PI"). For example, in the Medicare B Connecticut transition from United HealthCare to First Coast Service Options, Inc. only the incremental costs were charged to the transition (PI). An additional example is the current Multi Carrier System (MCS) transition, where only the incremental costs are being charged to this project.

- $32,781 of fees for services rendered by subcontractors that could not be supported with adequate documentation. These subcontractors were used to

support CMS's Y2K activities. And as such the invoices received for these subcontractors were paid and reported on the IER.

Appendix D – General Comments

The entire Draft Report asserts that BCBSFL was uncooperative during the course of the audit and appears to have been a major driver for many of the audit findings. Appendix D reiterates throughout that BCBSFL did not cooperate with the auditors. While we certainly recognize that we could have worked in better concert with the auditors and should have assured that they understood the information we supplied, BCBSFL strongly disagrees with the assertion we were uncooperative. After reviewing BCBSFL's responses to individual findings and to this section, we believe that it would be appropriate for Appendix D to be deleted from the report and that all references to a lack of cooperation by BCBSFL be similarly removed from the body of the report.

BCBSFL's Intent Was To Be Cooperative

The Draft Report characterizes BCBSFL as being intentionally uncooperative, an accusation that is both unfair and untrue. That was most certainly not our intent. While there may have been some occasional misunderstandings as to precisely what information was requested, as well as a few differences as to how quickly a small number of the many documentation requests could be produced, these sorts of incidents are not uncommon when an audit of a large Medicare contractor is conducted relating to expenditures that were incurred over a multi-year period beginning several years ago. The record shows that BCBSFL expended significant effort to be cooperative. The final audit report should recognize that effort and ensure that a few innocent misunderstandings are not equated with a lack of cooperation.

BCBSFL believes that Appendix D is wrong in substance and tone; however, the Company recognizes that it did not perform flawlessly. We understand and regret the frustration this caused the audit team. BCBSFL has and is continuing to take steps to ensure this will not happen again.

Damage to BCBSFL's Reputation

BCBSFL has been a Medicare intermediary and carrier since the beginning of the Medicare program. It is a trusted and valued partner of CMS and it would never impede the conduct of a federal audit.

The *ad hominem* nature of Appendix D suggests that many of the findings do not reflect objective application of the FAR cost principles. Appendix D is not justified and has the potential to cause grave harm to our name and reputation.

The OIG Audit Team's Experience Appears to Have Contributed to Some of the Issues

The audit team lacked experience with regard to auditing Medicare contractors' administrative expenses. Government Auditing Standards require that auditors collectively possess a thorough knowledge of government auditing and of the specific or unique environment in which the audited entity operates relative to the nature of the audit being conducted. The lead auditors' backgrounds were in fraud and abuse, banking, and hospital cost reporting. The lack of experience with the audit of Medicare intermediaries

and carriers was particularly unfortunate considering the size and complexity of our Medicare contracts—for example, BCBSFL's administrative budget, including Medigap and Crossover revenue, approximated $108M in 1998.

The audit team's lack of experience in auditing carriers and intermediaries is reflected in the Draft Findings 10 – 13. Appendix B of the Medicare contract clearly directs contractors on the approach to use to calculate ROI – the approach used by BCBSFL, but asserted to be incorrect by the auditors. Another example is the audit finding entitled "...Costs Incurred and Paid in Another Year...". If the auditors had a more complete knowledge of Medicare administration, they would have been familiar with CMS's established practice of forward funding under §208. Here, the audit team's lack of experience led them to view BCBSFL in a negative light when, in fact, all BCBSFL was doing was following CMS's instructions. This finding increased the audit results by $2.1 million.

The Lack of Dialogue was Problematic

Only after BCBSFL requests in January 2000, did the Company have the opportunity to have regular meetings with the auditors to discuss and review the progress of the audit. At that point, the audit had already been underway for over three months. While the auditors did suggest some frustration in their request for records, overall the Company was led to believe that the audit was progressing to OIG's satisfaction.

BCBSFL did not have adequate opportunity to explain or resolve any of the preliminary findings before the auditors left the field on May 12, 2000, since written descriptions of the issues/findings were just provided during the days immediately preceding May 12, 2000. Moreover, even though BCBSFL continued to provide information after May 12, 2000, it was not given an opportunity to comment or resolve any issues/findings prior to the issuance of the Draft Report in June 2001. If the dialogue had been more open, the issues could have been easily resolved and the perception of the Company being noncooperative would have been avoided.

The limited communication with BCBSFL continued after the May 12, 2000 meeting. At that meeting, the Company was told that the findings were merely preliminary and would be amended or eliminated once supporting documentation or missing information was supplied. Ultimately, BCBSFL provided over 500 documents to support the questioned costs claimed, and, as agreed to during this meeting, several boxes of additional material were subsequently sent to the auditors. However, notwithstanding the representation that the information would be evaluated, the audit report does not reflect that relevant aspects of this material was considered in the formulation of the draft report.

* * * * * *

Below, BCBSFL addresses each of the specific allegations regarding its alleged lack of cooperation cited in Appendix D. We request that our response be carefully considered,

as it clearly demonstrates the unreasonable and unfair characterization of the Company as being uncooperative. While the monetary findings can be disputed in a court of law, BCBSFL will not have an adequate way to recoup the damage to its reputation if the unfair characterization of its conduct remains in the final report. Hence, we request that Appendix D, as well as the statements in the report that relate to Appendix D, be deleted in their entirety.

Appendix D.1

Management Letters and Public Auditor Workpapers

BCBSFL's Internal Audit department was contacted on December 8, 1999 with a request for copies of the PricewaterhouseCoopers (PwC) management letters. Copies of the management letters were supplied just two days later, on December 10, 1999. However, Internal Audit personnel noted that the management letters in the files did not contain PwC's signature. Therefore, BCBSFL promptly requested signed copies from PwC. The signed copies of the management letters that were originally provided contained all of the substantive information that should have been necessary for the on-site work. The slight delay BCBSFL encountered in obtaining signed copies of the PwC letters had no bearing whatsoever on the performance of that work. This example does not support the auditors' assertion that the delay in producing signed letters proves that BCBSFL was uncooperative.

Moreover, the Draft Report does not reflect that two sets of workpapers from PwC were requested at different times during the review. Further, BCBSFL personnel voluntarily informed the auditors about the second set of workpapers in an effort to be helpful in assisting them to document the cost accounting system. This second set of workpapers was produced even though the audits did not relate to Medicare but rather to an audit for the FEP. With regard to this allegation, the following two points are significant:

- The first set of workpapers was for PwC's audit of the December 31, 1998 financial statements of the Company. PwC's letter requesting our consent to allow the auditors access to the workpapers is dated December 15, 1999. The auditors delayed communicating with PwC for several weeks after BCBSFL gave the auditors a PwC name and telephone number. Also, the letters were signed not 2.5 months later, as the audit report states, but rather just twenty-two workdays later on January 19, 2000. (This includes time from the preparation of the documents by PwC until delivery to BCBSFL). The audit team was responsible for most of the delay and, in any event, the delay was not accurately portrayed in the Draft Report.
- The second set of workpapers was for PwC's completion of the Blue Cross and Blue Shield Association Service Benefit Plan Workplan for the OPM Audit Guide for 1998. PwC's letter requesting BCBSFL's consent to allow the auditors access to these workpapers is dated February 7, 2000. These letters were signed twelve workdays later on February 23, 2000. (This includes time from the preparation of the document by PwC until delivery to BCBSFL). Again, this does not equate to a 2.5 month delay as is stated in the draft report.

Appendix D.2

Internal Audit Reports and Records of Time Spent

The Draft Report concedes that the first written request for internal audit reports was made to Internal Audit on November 3, 1999 and the Internal Audit reports were delivered on November 8, 1999, just three workdays later. Before delivering the reports, BCBSFL carefully confirmed the scope of the request with the auditors. The auditors told BCBSFL that they were requesting the internal audit reports for audits that were completed during the period FY 1995 to FY 1998 to ensure that an evaluation of internal controls in BCBSFL's Medicare operations was performed over a five-year period. These seven internal audit reports that BCBSFL produced were the same reports that BCBSFL listed in the BCBSFL's Internal Control Certifications. The Company also promptly provided copies of these Internal Control Certifications.

The listing of time spent that was provided also identified internal audits that were in progress, but not yet complete. Although these audits were also listed in the FY 1998 certification, copies of these reports were not requested. Further, the listing included time spent coordinating external audits, consulting on the CPE Certification, follow-up work, etc., as well as any corporate audits which may have benefited Medicare but were not part of the five-year plan for a review of Medicare operations. Time spent in the above activities would not result in issuance of an internal audit report. However, as part of the BCBSFL's Internal Control Certification process, any issues deemed to be reportable

conditions or material weaknesses relating to Medicare as a result of such a review would be reported in the certification.

As the draft report reflects, on December 22, 1999, the OIG audit team informally spoke with Internal Audit personnel and requested a full listing of internal audit reports. The normal procedure for such requests is to provide a listing of any audits that would have benefited Medicare, including corporate reviews that benefit many lines of business. Audits that were not relevant to Medicare, such as an audit of a private business claims area, would not be listed.

BCBSFL required time to research the internal audit allocation to answer the inquiries and to manually prepare a specific report of time spent. Unfortunately, the timekeeping system that Internal Audit used was not Y2K compliant and was no longer available to create a report. Research time was also required to determine whether numerous projects were related to specific audits of Medicare activities. There were a number of subsequent requests after January 21, 2000 as the data were being reviewed by the audit team. As each request was made, the auditors agreed to give BCBSFL personnel an appropriate length of time to perform the research work. In all instances, the turnaround time was actually five business days or less. Moreover, once agreement was reached on the schedule, no dissatisfaction with the timeliness of the responses was communicated to BCBSFL. The last of the series of responses was dated February 7, 2000.

What the above discussion shows is that the auditors were requesting a considerable amount of materials, a good deal of which was extraneous to the scope of an FACP audit and did not exist in the form the auditors wanted. Much of the subject matter of the requests went far beyond the Medicare contracts. Yet, in an effort to be fully cooperative, BCBSFL reacted positively and assembled the materials in a reasonable timeframe. This approach was treated as acceptable at the time. The draft report's assertion of this set of circumstances as an example of non-cooperation is unjustified, as the record clearly demonstrates that BCBSFL acted quickly and responsibly to comply with the requests.

Appendix D.3 – Executive Compensation

It would appear from the discussion that the audit report combines and perhaps confuses two separate documentation requests. The first is for Management Incentive Program (MIP) compensation and the second relates to the compensation for senior executives of BCBSFL. While the MIP information was supplied to the auditors on April 24, 2000, the auditors expressed their dissatisfaction with BCBSFL's delivery of documentation relating to executive compensation.

With regard to executive compensation, the audit team's original written request was made on January 7, 2000. The precise amount of BCBSFL's executive compensation is highly sensitive information. Accordingly, at a January 20, 2000 meeting, BCBSFL stated that it would be willing to release all of the executive compensation records being sought as soon as the auditors provided a written letter assuring BCBSFL that this information would not be improperly disclosed. This assurance was provided February 23, 2000, over four weeks later. Once provided with a letter, the information was promptly released on February 29, 2000. Some additional follow-up information was supplied on April 14, 2000, but all of the basic information relating to the compensation of our executives was delivered within six days after BCBSFL received the letter of non-disclosure.

Appendix D.4 – Y2K Costs

The Audit Report asserts that on January 3, 2000, a reconciliation between FY 1998 Medicare B Y2K costs claimed and the Y2K costs reported on the FY 1998 Medicare B FACP was requested. The government has interpreted BCBSFL's response that the costs were included in the "17100" series of activities to mean that the Company did not have supporting documentation and that these costs were reported without supporting documentation.

It continues to remain unclear as to what "reconciliations" were expected for Y2K costs. Our response did not suggest that the Company did not have any supporting documentation in its files. As previously explained during the on-site work and in BCBSFL's response to Finding 1a – Medicare A and Medicare B Y2K Cost, BCBSFL made every effort to follow CMS's instructions for reporting and claiming Y2K costs. CMS instructed its contractors to report all Y2K expenditures incurred in FY 1999 against the FY 1998 NOBA on the "Y2K IER." For the FY 1998 FACP, CMS instructed its contractors to report only the Y2K funds expended in FY 1998 for Y2K and to re-submit the FY 1998 FACP for FY 1999 Y2K costs when the FY 1998 funds were exhausted. Reconciliations of these costs to the adjustments recorded on the Medicare A and Medicare B FACPs and the October 1998 – September 1999 Y2K IERs are provided in Book 2, Tabs 1a-3.

These Y2K reports were available during the fieldwork. It was BCBSFL's understanding that Y2K costs were not included in the scope of this audit since one OIG audit had already been performed to examine Y2K costs for FY 1998 and the October – June, 1999 audit was in the process of being finalized during the same time that the FY 1995-FY 1998 administrative cost audit team was on-site. Not surprisingly, the number of audits being conducted on Y2K led to considerable duplication of BCBSFL's work effort.

It is unfortunate that there was an apparent lack of effective communication related to the Y2K costs reporting process. This finding relating to Y2K costs was attributable not to BCBSFL's unwillingness to cooperate, but rather appears to be the result of a lack of the auditors'understanding of CMS's instructions for reporting Y2K costs. Moreover, with all of the audits occurring around the same time, some confusion as to what records each audit team needed is understandable. Ultimately, each of the audit teams received the information they needed.

Appendix D.5 - Non-Executive Compensation

Appendix D.5.a. – Payroll Transactions and Related Journal Entries

Payroll was notified on December 20, 1999, about the audit team's request for payroll records. Due to the timing of the request, which coincided both with various crucial year-end tasks required of the payroll staff and the Christmas holidays, the data was not provided until the week of January 10, 2000. This information was extracted from the payroll system on January 10, 2000, and was delivered soon thereafter. On January 17, 2000, the Company responded to a request for additional information. The Company was notified about some missing pages on January 26, 2000. It promptly supplied all of the missing pages that were requested at that time.

From the documentation supplied, the auditors requested explanations for the "y-adjustments." Typically, any manual adjustments to an employee's pay for timesheet corrections, etc., are signified by a y-adjustment or a voided check on the payroll system. The Company supplied this response on January 17, 2000. Because the documentation was in Records Retention, Payroll provided the audit team with an explanation of what the adjustments were and demonstrated that the information was reliable and accurate. From the Company's understanding at that time, the response was accepted and the

process understood. Subsequently, the Company learned that its response was not sufficient and it then provided all of the data that was originally requested. The back-up documentation proved to be a combination of y-adjustments and voided checks. BCBSFL therefore provided the vast majority of the information to the audit team in a timely manner.

BCBSFL received multiple requests for payroll information. BCBSFL treated each of these requests as a priority, even in the face of the year-end payroll-processing deadline and preparations for potential Y2K issues. As soon as additional information was requested, the payroll staff supporting the effort responded as best they could and tried to ensure the delivery of the information in a timely manner.

A sinister motivation should not be ascribed to BCBSFL simply because all information was not supplied at the time of the first request. Once BCBSFL understood the information needed, the documentation was delivered in a very timely manner. If there were not a clear understanding regarding what was being sought, both parties must accept responsibility for imperfect communications. BCBSFL recognizes some of the misunderstanding most assuredly was its responsibility. However, there is simply no basis to conclude that the delay was intentional or reflected a lack of cooperation.

Appendix D 5.b and D.5.c
Vendor Invoices and Vendor Contracts

In January 2000, in order to better control the many overlapping requests BCBSFL was receiving from the auditors for follow-up information, the Company asked the auditors for hard copies of their document requests and to discontinue sending informal e-mail requests for records. By that time, the number of documents requested by auditors had grown to approximately 559 (excluding contracts). The records were not located in a central location. The effort to retrieve the many records required coordination between several offices scattered throughout the city, as well as in off-site storage.

In addition to retrieving documents from different sites, the assigned BCBSFL staff coordinated nearly all data gathering and communication so that the audit could be completed in a timely manner. During late February and March of 2000, half of the resources dedicated to records retrieval was shifted towards maintaining mobility of Cost For Pricing access issues, pending Payroll, and MIP issues. As the auditors were aware at the time, these issues assumed a higher priority than vendor invoices and contracts and consumed a considerable amount of BCBSFL's time.

Given the large number of documents requested, some priority had to be assigned. To characterize BCBSFL as being uncooperative because some documents were not produced as soon as other higher priority records is simply not reasonable.

Appendix D 5.d – Payroll Taxes and Payroll Adjustments

The audit team asserts that on January 26, 2000 it requested support for payroll tax entries for six employees for a single pay period. The fact that the requested support was not provided until March 20, 2000 is cited as evidence of BCBSFL's lack of cooperation.

BCBSFL recognized the importance of the documentation requested. Unfortunately, the information requested was not a routine production job - a fact that the Draft Report did not appear to reflect. Additionally, at the time of this request, BCBSFL Payroll staff was in the midst of implementing a new payroll system and was also immersed in year-end payroll processing activities (i.e., W-2 forms, 1099's, etc.) which required a significant amount of time and resources. BCBSFL does not agree with the report's characterization that the time it took to respond to this request evidences noncooperation, in light of the many other audit record requests and other year-end activities (i.e., "Y" Adjustments, Executive Compensation, Management Incentive Program, etc.) that were simultaneously being conducted.

BCBSFL most assuredly regrets the time it took to provide the six payroll tax computations. However, it respectfully submits that these data items would not impede the progress of the audit. The relatively short time it takes to review and verify these computations are not in the audit's critical path and therefore could not have caused any delay in the work.