



## Memorandum

**JUN 25 1996**

Date  
June Gibbs Brown  
Inspector General *June G Brown*

Subject  
Audit of Administrative Costs - Medicare Parts A and B--Blue Cross and Blue Shield of Michigan (A-05 -94-00064)

To  
Bruce C. Vladeck  
Administrator  
Health Care Financing Administration

This memorandum is to alert you to the issuance on June 27, 1996 of our final report. A copy is attached.

The audit covered the costs claimed on Blue Cross and Blue Shield of Michigan's (BCBSM) final administrative cost proposals for Parts A and B of the Medicare program for Fiscal Years 1990 through 1993. Of the total claimed, we are recommending financial adjustments of \$15,609,718 because BCBSM:

- o claimed \$2,361,864 for unallowable strategic planning costs. These costs did not directly benefit the Medicare program.
- o failed to reduce its total allowable costs by \$2,056,288 for complementary credits due the Medicare program from BCBSM's Medicare secondary payer activities.
- o charged Medicare \$1,318,296 for unallowable productivity investments. These costs were in excess of the Health Care Financing Administration's (HCFA) funding limits.
- o allocated \$1,227,107 to the Medicare program for implementation and maintenance of a claims processing system contrary to a memorandum of advanced understanding with HCFA.
- o overstated Medicare costs by \$594,913 for various items which were unreasonable, unallowable, not in accordance with Federal regulations, and did not benefit the Medicare program. These costs included memberships in private country clubs, personal use of automobiles, excessive executive compensation, costs associated with a special early retirement program and executive incentive awards.

Page 2- Bruce C. Vladeck

The BCBSM also claimed \$8,051,250 of otherwise allowable costs which are not eligible for reimbursement in accordance with applicable Federal regulations and terms of the Medicare contract because they were in excess of HCFA 's notice of budget authorization.

In its response to our draft report, BCBSM generally did not concur with our findings and recommendations. The HCFA officials did not formally respond to the draft report but in discussions with them throughout the audit were supportive of our audit methodology.

For further information, contact:

Paul P. Swanson  
Regional Inspector General  
for Audit Services, Region V  
(312) 353-2618

Attachments

**Department of Health and Human Services**

**OFFICE OF  
INSPECTOR GENERAL**

**AUDIT OF ADMINISTRATIVE COSTS -  
MEDICARE PARTS A AND B -  
BLUE CROSS AND BLUE SHIELD OF  
MICHIGAN**



**JUNE GIBBS BROWN**  
**Inspector General**

**JUNE 1996**  
**A-05-94-00064**



DEPARTMENT OF HEALTH AND HUMAN SERVICES

REGION V  
105W ADAMS ST.  
CHICAGO, ILLINOIS 60603-6201

OFFICE OF  
INSPECTOR GENERAL

Common Identification No. A-05 -94-00064

Mr. Mark R. Bartlett  
Vice President and Controller  
Blue Cross and Blue Shield  
of Michigan  
600 Lafayette East  
Detroit, Michigan 48226

Dear Mr. Bartlett:

Enclosed are two copies of an Office of Inspector General (OIG) audit report entitled "AUDIT OF ADMINISTRATIVE COSTS CLAIMED UNDER PARTS A AND B OF THE HEALTH INSURANCE FOR THE AGED AND DISABLED PROGRAM FOR FISCAL YEARS 1990 THROUGH 1993". A copy of this report will be forwarded to the action official noted below for her review and any action deemed necessary.

Final determination as to actions taken on all matters reported will be made by the HHS action official named below. 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 on the final determination.

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), OIG reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR Part 5.)

To facilitate identification, please refer to the above Common Identification Number in all correspondence relating to this report.

Sincerely,

Paul Swanson  
Regional Inspector General  
for Audit Services

Enclosures

Direct Reply to HHS Action Official:  
M. Daly Vargas  
Associate Regional Administrator

SUMMARY

Blue Cross and Blue Shield of Michigan (BCBSM) claimed Medicare Part A and B administrative costs for the period October 1, 1989 through September 30, 1993, as follows:

<u>Fiscal</u> <u>Year</u>	<u>Part A</u>	<u>Part B</u>	<u>Total</u>
1993	\$17,030,588	\$42,006,808	\$ 59,037,396
1992	15,705,614	44,404,572	60,110,186
1991	14,996,014	40,732,038	55,728,052
1990	<u>15,562,398</u>	<u>37,701,658</u>	<u>53,264,056</u>
Total	<u>\$63,294,614</u>	<u>\$164,845,076</u>	<u>\$228,139,690</u>

Of the \$228,139,690 in administrative costs claimed, we consider \$212,529,972 to be acceptable and recommend a financial adjustment of \$15,609,718. Details are provided in Exhibits A through J and summarized in the following paragraphs.

**COSTS IN EXCESS OF APPROVED BUDGET -- \$8,051,250**

BCBSM claimed costs in excess of the final Notice of Budget Approvals ( NOBAS ) which resulted in allowable Medicare costs being overstated by \$8,051,250. The NOBAs establish the limits for reimbursement of allowable administrative costs and may not be exceeded without HCFA's approval. We adjusted BCBSM's final administrative costs claimed by the unallowable costs identified during our audit to determine total allowable costs incurred by BCBSM. We found that allowable costs claimed exceeded the NOBAs by \$8,051,250. Since the NOBAs establish the limits for reimbursement of allowable administrative costs, we are recommending financial adjustment of the \$8,051,250.

**UNALLOWABLE COSTS -- \$7,558,468**

**Strategic Planning.** Medicare costs were overstated by \$2,361,864 pertaining to long-range management planning costs that did not directly benefit the Medicare program. The costs, identified by BCBSM as Strategic Planning costs, were incurred during fiscal years 1990 through 1993 for the future overall development of BCBSM's business and benefited the entire company. However, these costs were subsequently allocated through the Vice President of Government Programs cost center using allocation rates applicable to the first six months of fiscal year 1994. This cost center and the allocation rates did not represent an equitable allocation of these costs. As a result, Medicare costs were overstated by \$2,361,864.

**Complementary Credits.** BCBSM did not include its Medicare Secondary Payer (MSP) activities in the complementary credits calculation. As a result, the complementary credits were understated, and total costs claimed were overstated by \$2,056,288.

**Productivity Investments.** BCBSM claimed \$1,318,296 for Productivity Investments (PI) projects that exceeded the amounts approved by HCFA. Since the cost for each PI project requires specific prior approval by HCFA, we are questioning the excess of \$1,318,296.

**Medicare Part A Claims Processing System.** BCBSM claimed \$1,227,107 for the implementation (\$1,121,479) and maintenance (\$105,628) of a new Medicare Part A claims processing system that are unallowable. Prior to purchasing the new system, the Federal government and BCBSM signed a Memorandum of Advanced Understanding (MAU) which specifically identified implementation costs as unallowable and limited allowable central maintenance costs. We are questioning \$1,121,479 pertaining to implementation costs and \$105,628 in central maintenance costs that exceeded the agreed upon limit.

**Miscellaneous Income Credits.** Miscellaneous income credits were understated and total costs claimed were overstated by \$159,560. BCBSM did not identify all applicable miscellaneous income credits nor did it use an allocation method that ensured all applicable credits were allocated to Medicare. As a result, we are questioning the \$159,560.

**Miscellaneous Unallowable Costs.** BCBSM claimed \$152,359 in miscellaneous costs that were unallowable. These costs included entertainment, personal use of automobiles, and other items that did not benefit Medicare.

**Executive Compensation.** Executives at BCBSM received increases in compensation that were greater than increases measured by the Employment Cost Index (ECI). We believe that increases in compensation in excess of the ECI are unreasonable. Excessive compensation of \$149,049 was allocated to Medicare.

**Special Early Retirement Program.** BCBSM claimed \$109,988 of pension costs that were unallowable. The costs were not calculated or funded in accordance with the applicable Federal regulations pertaining to pensions. We are questioning the \$109,988.

**Executive Incentive Awards.** BCBSM allocated executive bonuses to Medicare through cost centers that were inconsistent with its allocation plan and the allocation of all other executive costs. As a result, Medicare costs were overstated by \$23,957.

In a written response to our draft report, BCBSM generally did not concur with our findings and recommendations. We have summarized BCBSM's responses following the individual findings and

recommendations and **have** provided our comments where appropriate. The full text of BCBSM's written response has been included as an Appendix to this report.

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## INTRODUCTION

### BACKGROUND

Health Insurance for the Aged and Disabled (Medicare) was established by Title XVIII of the Social Security Act and consists of two distinct parts. Hospital Insurance (Part A) provides protection against the cost of hospital and related care. Supplemental Medical Insurance (Part B) is a voluntary program that covers physician services, hospital outpatient services, and certain other health services.

The Medicare program is administered at the Federal level by the Health Care Financing Administration (HCFA). Title XVIII provides that HCFA contract with private insurance companies to process claims, record and collect overpayments, and execute the day-to-day operations of the program. For each of these contracts, HCFA and the respective contractor negotiate a budget amount of administrative costs necessary to administer the program. Subsequently, HCFA issues a Notice of Budget Approval (NOBA) to the contractor which establishes the maximum annual costs that can be claimed for reimbursement on the year-end Final Administrative Cost Proposal (FACP).

Through the end of fiscal year 1994, the Medicare program in Michigan was administered by BCBSM. The BCBSM operated as both a fiscal intermediary for the Medicare Part A program and a carrier for the Medicare Part B program. The HCFA opted not to renew BCBSM'S contracts for fiscal year 1995.

### SCOPE OF AUDIT

Our audit was conducted in accordance with generally accepted government auditing standards. The objective was to determine if Medicare Part A and Part B administrative costs claimed by BCBSM for fiscal years (FYs) 1990 through 1993 were reasonable, allocable, and allowable.

Subsequent to HCFA'S decision not to renew BCBSM'S contracts for FY 1995, BCBSM revised the FACPS for the four year period. We reviewed the revised total Part A and Part B administrative costs of \$228,139,690.

We examined the administrative costs claimed by BCBSM to the extent that we considered necessary to determine if amounts claimed were in accordance with applicable Federal requirements, policies, and program instructions. Our examination included audit procedures designed to achieve our objective and included a review of accounting records and supporting documentation.

In addition, our audit included a review of increases in executive compensation. Our executive compensation findings will be forwarded to our Office of Audit Services in Region III for inclusion in a national report.

The audit excluded a review of pension segmentation. A separate audit of the BCBSM pension plan for compliance with segmentation requirements will be performed at a later date.

Audit fieldwork was performed at BCBSM'S offices in Detroit, Michigan during the period June 1994 through March 1995.

## FINDINGS AND RECOMMENDATIONS

For the period of October 1, 1989 through September 30, 1993, BCBSM claimed total administrative costs of \$228,139,690. Of this amount, we consider \$212,529,972 to be acceptable and recommend financial adjustment of \$15,609,718. The financial adjustment includes \$8,051,250 of costs claimed in excess of the approved budget and \$7,558,468 of unallowable costs.

### COSTS CLAIMED IN EXCESS OF APPROVED BUDGET

Article VI, paragraph C, of the Medicare Part A contract and Article XVI, paragraph C, of the Medicare Part B contract, specify that costs claimed by the contractor cannot exceed the NOBAs without prior approval of the Secretary. Our review of total costs claimed and the final NOBAs showed that BCBSM claimed costs in excess of the final NOBAs, as follows:

#### Part A

	<u>costs Claimed</u>	<u>NOBA</u>	<u>Costs Over the NOBA</u>
FY 1993	\$17,030,588	\$15,952,097	\$1,078,491
FY 1992	15,705,614	14,058,020	1,647,594
FY 1991	14,996,014	13,924,500	1,071,514
FY 1990	<u>15,562,398</u>	<u>14,034,800</u>	<u>1,527,598</u>
Sub-total	<u>\$63,294,614</u>	<u>\$57,969,417</u>	<u>\$5,325,197</u>

#### Part B

	<u>costs Claimed</u>	<u>NOBA</u>	<u>Costs Over the NOBA</u>
FY 1993	\$ 42,006,808	\$ 39,926,050	\$2,080,758
FY 1992	44,404,572	39,411,200	4,993,372
FY 1991	40,732,038	38,864,500	1,867,538
FY 1990	<u>37,701,658</u>	<u>37,502,900</u>	<u>198,758</u>
Sub-total	<u>\$164,845,076</u>	<u>\$155,704,650</u>	<u>\$9,140,426</u>
Totals	<u>\$228,139,690</u>	<u>\$213,674,067</u>	<u>\$14,465,623</u>

Our review disclosed that the costs claimed in each fiscal year contained unallowable amounts which totalled \$7,558,468 for the four year period. We reduced the amounts claimed in excess of the NOBA by the applicable unallowable costs. After adjusting for unallowable costs, we determined that BCBSM still incurred costs in excess of the NOBA for fiscal years 1991 through 1993. Except for exceeding the NOBA, these costs would otherwise be considered allowable costs. In fiscal year 1990, the adjustment for unallowable costs reduced the amount of acceptable costs claimed below the NOBA.

As a result of these adjustments, allowable costs claimed exceeded the NOBA by \$8,051,250, as shown in the table that follows.

PART A

	costs Claimed Over <u>the NOBA</u>	Unallowable costs	Revised Costs Claimed Over (Under) <u>the NOBA</u>	Allowable Costs Over <u>the NOBA</u>
FY 1993	\$1,078,491	\$ 660,176	\$ 418,315	\$ 418,315
FY 1992	1,647,594	549,454	1,098,140	1,098,140
FY 1991	1,071,514	632,884	438,630	438,630
FY 1990	<u>1,527,598</u>	<u>1,532,734</u>	<u>(5,136)</u>	<u>0</u>
Sub-total	<u>\$5,325,197</u>	<u>\$3,375,248</u>	<u>\$1,949,949</u>	<u>\$1,955,085</u>

PART B

	costs Claimed Over <u>the NOBA</u>	Unallowable costs	Revised Cost Claimed Over ( Under ) <u>the NOBA</u>	Allowable Costs Over <u>the NOBA</u>
FY 1993	\$2,080,758	\$ 859,854	\$1,220,904	\$1,220,904
FY 1992	4,993,372	1,157,691	3,835,681	3,835,681
FY 1991	1,867,538	827,958	1,039,580	1,039,580
FY 1990	<u>198,758</u>	<u>1,337,717</u>	<u>(1,138,959)</u>	<u>0</u>
Sub-total	<u>\$9,140,426</u>	<u>\$4,183,220</u>	<u>\$4,957,206</u>	<u>\$6,096,165</u>
Totals	<u>\$14,465,623</u>	<u>\$7,558,468</u>	<u>\$6,907,155</u>	<u>\$8,051,250</u>

Note : Unallowable costs in FY 1990 offset Part A and Part B costs claimed over the NOBA.

BCBSM officials contend that the Medicare contracts are cost reimbursement contracts which should reimburse all allowable costs incurred. However, in accordance with the Medicare contract(s) , BCBSM is only entitled to allowable costs up to the total NOBA. Consequently, BCBSM is not entitled to reimbursement for the \$8,051,250 of allowable costs that exceed the NOBA.

Recommendations

We recommend that BCBSM reduce their FACPS by \$8,051,250, as follows:

	<u>Part A</u>	<u>Part B</u>	<u>Total</u>
FY 1993	\$ 418,315	\$1,220,904	\$1,639,219
FY 1992	1,098,140	3,835,681	4,933,821
FY 1991	<u>438,630</u>	<u>1,039,580</u>	<u>1,478,210</u>
Totals	<u>\$1,955,085</u>	<u>\$6,096,165</u>	<u>\$8,051,250</u>

## Auditee Comments

BCBSM disagrees with the finding. They contend that the NOBAs do not bar recovery because the contracts are cost reimbursable to the extent of actual administrative costs. BCBSM believes that its periodic provision of cost reports and other data provided HCFA with ample and timely notice that its Medicare contract costs would exceed the NOBA. They contend that they were consistent with the cost reimbursement provisions of the contracts and are entitled to recover these otherwise allowable costs notwithstanding HCFA's failure to adjust the NOBAs.

## OIG Response

In accordance with the Medicare contracts, BCBSM is only entitled to allowable costs up to the total NOBA. We believe the fact that HCFA did not adjust the NOBA after receiving BCBSM's cost reports and other data indicating BCBSM'S costs would exceed the NOBA, supports the premise that HCFA intended the NOBA to be a cap on Medicare administrative costs. Accordingly, we continue to recommend that BCBSM make the appropriate financial adjustment as reported.

## UNALLOWABLE COSTS ALLOCATED TO MEDICARE

BCBSM allocated \$7,558,468 of administrative costs to the Medicare program that were unallowable in accordance with applicable Federal regulations and terms of the Medicare contract. The unallowable costs are summarized in the following paragraphs.

**STRATEGIC PLANNING.** Costs claimed were overstated by \$2,361,864 because long-range management planning costs were allocated to Medicare using a rate other than the corporate rate. The costs, identified by BCBSM as "Strategic Planning" costs, were incurred during fiscal years 1990 through 1993 for the future development of BCBSM'S business and benefited the entire company. The Federal regulations, 48 CFR 31.205-12, state that economic planning costs, which includes long-range management planning costs, that are concerned with the future overall development of the contractor's business are allowable as properly allocated indirect costs. Federal regulations, 48 CFR 31.205-18(b) (2), further state that costs that clearly benefit the entire company should be allocated through the corporate rate for general and administrative (G&A) costs .

The original FACPs for FYs 1990 through 1993 did not include strategic planning costs. Since BCBSM had not claimed these costs, they had not established how these costs should be allocated. In 1994, when BCBSM submitted revised FACPs for FYs 1990 through 1993, these costs were allocated through the Vice President of Government Programs cost center using allocation rates applicable to the first six months of fiscal year 1994. This allocation method resulted in all strategic planning costs being allocated only to the Medicare

program and the Federal Employees Program (FEP) . Because these costs benefited the entire company, they should have been allocated to all lines of business.

In accordance with the applicable Federal regulations, we re-allocated these costs using BCBSM's corporate G&A rate applicable to the period in which the cost were incurred. We determined that Medicare costs were overstated by \$2,361,864.

### Recommendations

We recommend that BCBSM make a financial adjustment of \$2,361,864, as follows:

	<u>Part A</u>	<u>Part B</u>	<u>Total</u>
FY 1993	\$143,770	\$ 594,790	\$ 738,560
FY 1992	172,666	699,004	871,670
FY 1991	81,811	338,204	420,015
FY 1990	<u>64,217</u>	<u>267,402</u>	<u>331,619</u>
	<u>\$.462,464</u>	<u>\$1,899,400</u>	<u>\$2,361,864</u>

### Auditee Comments

BCBSM disagrees with the finding stating that the Government Business Group (GBG) is a separate business unit that was created for Federal government contracts. They state that during the audit period there were three contracts operating within the GBG; Medicare Part A, Part B and FEP. The G&A costs incurred within the GBG during the audit period were to manage the operations of the business unit. One of the G&A functions was the strategic planning operation. The Auditee contends, therefore, that the strategic planning costs are allocable only to the three contracts that were operating within the GBG unit and not to the entire BCBSM organization.

### OIG Response

BCBSM made a unilateral decision to incur these costs primarily in anticipation of securing additional government contracts. In most instances strategic planning costs and the additional contracts that were pursued had no direct relationship to the specific activities that BCBSM was required to perform under the terms and conditions of their current Medicare contracts. Our review disclosed no specific evidence that the costs incurred provided any measurable benefit to the Medicare program. In addition, BCBSM's response did not address that these costs were allocated based on another cost centers' allocation percentages using rates that were developed to allocate costs incurred during the first six months of 1994. Accordingly, we continue to recommend that BCBSM make the appropriate financial adjustment as reported.

COMPLEMENTARY CREDITS. Because BCBSM did not include the appropriate Medicare Secondary Payer (MSP) activities in the complementary credits calculation, costs claimed were overstated by \$2,056,288. The Medicare Carrier and Intermediary manuals state that any cost center benefiting the complementary claims process must be allocated to that line of business. The activities in the contractor's MSP cost centers meet this criteria. These activities are necessary for BCBSM's own programs to ensure compliance with the Federal MSP laws and regulations.

In 1994, BCBSM completed studies of their Medicare Part A and Part B complementary credit procedures. The studies state that the methodology for calculating the Medicare complementary credit was carefully scrutinized and that the calculation was revised to reflect operational changes over the past few years. One of these revisions was BCBSM's decision to include the Part A and Part B MSP cost centers in future calculations of the applicable complementary credits. However, the study provided that the MSP cost centers only partially benefit the complementary process. Therefore, only a portion of the cost center expense was used to calculate the credit .

Our review of available documentation disclosed no evidence to support BCBSM'S contention that the MSP costs centers only partially benefit the complementary process. The MSP cost centers should be allocated the same as other related Medicare claims processing cost centers that have direct contact with Medicare claims . Accordingly, we recalculated the complementary credits using total costs of the MSP cost centers and BCBSM'S established rates for Medicare claims processing activities.

### Recommendations

We recommend that BCBSM make a financial adjustment of \$2,056,288, as follows:

	<u>Part A</u>	<u>Part B</u>	<u>Total</u>
FY 1993	\$ 361,152	\$178,375	\$ 539,527
FY 1992	341,008	206,253	547,261
FY 1991	405,630	152,070	557,700
FY 1990	<u>283,091</u>	<u>128,709</u>	<u>411,800</u>
	<u>\$1,390,881</u>	<u>\$665,407</u>	<u>\$2,056,288</u>

### Auditee Comments

BCBSM disagrees that the activities of the MSP cost center benefited the complementary insurance process and contends that they should not have been included with the complementary insurance credit . Specific comments provide that the MSP activity is designed to determine the coverage exposure of the government only



and does not add value to the processing of the complementary claim. Also, that BCBSM'S complementary credit calculation has consistently followed this methodology which has been approved by HCFA in prior audits.

BCBSM now maintains that the studies that were provided during the audit were inaccurate and if the Medicare contract had been renewed, the studies would have been amended to exclude the MSP cost centers. They also state that the studies focused on cost center activities as of FY 1994 and would not have been retroactively applicable because the functionality of the areas in question did not change until FY 1994.

### **OIG Response**

BCBSM has not given us any documentation to support their contention that the studies they provided us during our audit were inaccurate . Although BCBSM claims that MSP did not benefit the complementary claims process and that the aforementioned studies were to be amended to reflect this conclusion, they provided no documented evidence supporting their position. Further, in July 1994 we specifically asked BCBSM to provide us with evidence supporting any agreements or letters of understanding that BCBSM had with Medicare regarding complementary credit. BCBSM officials did not give us any supporting documentation for such approvals or agreements .

The Federal guidelines provide that an activity would be determined to benefit complementary insurance if that activity would have been necessary in order to fulfill the terms of the complementary contract or normal claims processing requirements. BCBSM has a totally integrated claims processing system and the complementary identifier is part of the Medicare claim. BCBSM has provided no documented evidence to refute our opinion that the MSP cost centers should be allocated the same as other related Medicare claims processing cost centers that have direct contact with Medicare claims. Therefore, we continue to recommend that BCBSM make the appropriate financial adjustment as reported.

**PRODUCTIVITY INVESTMENTS.** The BCBSM claimed \$1,318,296 for productivity Investment (PI) projects that exceeded the amounts approved by HCFA. Article VI, paragraph (E) of the Medicare Part A contract and Article XVI, paragraph (E) of the Medicare Part B contract, state that the Secretary shall furnish a certification of funding availability. This certification of funding availability shall be a ceiling on reimbursable expenditures which may not be exceeded.

The HCFA authorized BCBSM to perform special PI projects that were generally in addition to the normal processing of Medicare claims. Although the PI projects are reimbursed through the FACPs, they are

considered in addition to the regular budget process and are specifically identified in the NOBAs. We found that costs claimed for several PI projects exceeded the funding limits specified in the NOBAs.

**Recommendations**

We recommend that BCBSM make a financial adjustment of \$1,318,296, as follows:

	<u>Part A</u>	<u>Part B</u>	<u>Total</u>
FY 1993	\$ 62,855	\$ 0	\$ 62,855
FY 1992	0	167,576	167,576
FY 1991	43,100	204,034	247,134
FY 1990	<u>14,353</u>	<u>826,378</u>	<u>840,731</u>
	<u>\$120,308</u>	<u>\$1,197,988</u>	<u>\$1,318,296</u>

**Auditee Comments**

BCBSM disagrees with the finding for the same reasons rebutting the finding concerning costs claimed in excess of the NOBAs. The Auditee contends that it provided HCFA with timely and sufficient notice of projected and incurred PI costs and requested that HCFA provide adequate funding.

**OIG Response**

Since PI projects are not included in the regular budget process, the projects and the related funding for these projects must be approved by HCFA. BCBSM made a unilateral decision to incur costs in excess of the approved funding without the required HCFA approvals. Accordingly, we continue to recommend that BCBSM make the appropriate financial adjustment as reported.

**MEDICARE PART A CLAIMS PROCESSING SYSTEM.** BCBSM claimed unallowable costs of \$1,227,107 for the implementation and maintenance of a new Medicare Part A claims processing system. Prior to purchasing the new system, BCBSM and HCFA signed a Memorandum of Advanced Understanding (MAU) pertaining to the allowability of costs associated with BCBSM'S licensing, implementation, use, and maintenance of the new system. The MAU stated that direct or indirect costs attributed to the licensing and implementation of the system shall not be considered allowable costs, and, therefore, the Secretary shall not pay for any of these costs. The MAU further provided that central maintenance costs were limited to \$150,000 for the first year of the maintenance

contract. Our review showed that BCBSM claimed implementation costs of \$1,121,479 and central maintenance costs of \$105,628 in excess of the limitations established in the MAU.

### Recommendations

We recommend that BCBSM make a financial adjustment of \$1,227,107, as follows:

	<u>Part A</u>
FY 1991	\$ 86,878
FY 1990	<u>1,140,229</u>
	<u>\$1,227,107</u>

### Auditee Comments

BCBSM stated that they are presently reviewing the matter and will respond to our finding when they can do so on a fully informed basis.

#### OIG Response

During our audit field work, we requested and examined all available information provided by BCBSM. On February 1, 1995, BCBSM sent a message, via electronic mail, to selected BCBSM personnel that were involved with different aspects of the purchase and implementation of the claims processing system requesting any documentation pertaining to these costs. No additional information was ever provided to the OIG auditors. Subsequent to the issuance of the draft report and again at the exit conference, OIG auditors were available to answer questions and share information. BCBSM officials never requested any additional information or clarification. Accordingly, we continue to recommend that BCBSM make the appropriate financial adjustment as reported.

**MISCELLANEOUS INCOME CREDITS.** Costs claimed were overstated by \$159,560 because BCBSM did not account for all miscellaneous income and used an improper allocation methodology. Miscellaneous income includes advance seminar fees, income from subsidiary operations, and revenue from electronic claims submission.

Federal regulations at 48 CFR 31.201-5 state that the applicable portion of any income relating to any allowable cost shall be credited to the Government as a cost reduction or by cash refund.

The BCBSM quantified the miscellaneous income received but, as a result of computation errors, understated the total income allocable to Medicare. In addition, BCBSM allocated this income based on a cost center and cost center rates that were inconsistent with its established plan for allocating "Corporate" items. We identified the appropriate amount of allocable income and reallocated this amount using BCBSM's corporate G&A rate.

### Recommendations

We recommend that BCBSM make a financial adjustment of \$159,560, as follows:

	<u>Part A</u>	<u>Part B</u>	<u>Total</u>
FY 1993	\$20,443	\$ 17,154	\$ 37,597
FY 1992	14,256	20,689	34,945
FY 1991	(2,222)	68,574	66,352
FY 1990	<u>1,871</u>	<u>18,795</u>	<u>20,666</u>
	<u>\$34,348</u>	<u>\$125,212</u>	<u>\$159,560</u>

### Auditee Comments

BCBSM generally concurred with our finding and recommendations and agrees to settle the finding provided it is part of a global settlement of all cost claims relating to their Medicare contracts.

**MISCELLANEOUS UNALLOWABLE COSTS.** The BCBSM claimed \$152,359 in miscellaneous costs that were unallowable. These costs included entertainment, personal use of automobiles, and other items that did not benefit Medicare. Details of these unallowable costs are provided in the following paragraphs.

**Entertainment.** The BCBSM claimed \$39,700 of unallowable entertainment costs. The costs included memberships in private country clubs and social clubs, Board of Directors dinner, and assorted social activities. Federal regulations, 48 CFR 31.205-14, states that costs of amusement, diversion, and social activities are unallowable. In addition, costs of membership in social, dining, or country clubs are also unallowable.

**Personal Use of Automobiles.** The BCBSM claimed \$58,446 that pertained to personal use of executives' privately-owned automobiles. Federal regulations, 48 CFR 31.201-4, states that a cost is allocable to a Government contract if it (i) is incurred specifically for the contract, (ii) benefits both the contract and other work, and can be distributed to them in reasonable proportion of benefits received, or (iii) is necessary to the overall operation of the business. The executives' personal use of their

automobiles does not meet any of the above criteria and, therefore, is an unallowable cost.

**Computation Errors in Preparation of FACP.** The BCBSM's FY 1993 Medicare Part A costs included \$54,213 of costs which were not supported by the accounting records. A clerical error in compiling total costs allocable to Medicare resulted in BCBSM inadvertently including costs that were not incurred. Federal regulations, 48 CFR 31.201-1, state that the total cost of a contract is the sum of the allowable direct and indirect costs incurred.

### Recommendations

We recommend that BCBSM make a financial adjustment of \$152,359, as follows:

	<u>Part A</u>	<u>Part B</u>	<u>Total</u>
FY 1993	\$61,517	\$22,816	\$ 84,333
FY 1992	7,590	25,578	33,168
FY 1991	6,517	21,258	27,775
FY 1990	<u>1,754</u>	<u>5,329</u>	<u>7,083</u>
	<u>\$77,378</u>	<u>\$74,981</u>	<u>\$152,359</u>

### Auditee Comments

BCBSM concurred with our findings and recommendations and agrees to settle the finding provided it is part of a global settlement of all cost claims relating to their Medicare contracts.

**EXECUTIVE COMPENSATION.** The BCBSM claimed \$149,049 pertaining to increases in executive compensation that are unreasonable. Eleven executives at BCBSM received increases in compensation during our audit period that were greater than increases measured by the Employment Cost Index (ECI) established by the Department of Labor's Bureau of Labor Statistics. We believe that increases in compensation in excess of the ECI are unreasonable.

The ECI represents dozens of indices that are calculated for various occupational and industry groups to measure the rate of change in employee compensation. It is a fixed-weight index at the occupational level and eliminates the effects of employment shifts among occupations. The ECI is distinguished from other surveys in that it (1) includes costs incurred by employers for employee benefits in addition to salaries and wages; and (2) covers all establishments and occupations in both the private nonfarm and public sectors. Our calculations used the index for executive compensation because we considered it to be the most equitable and relevant.

Federal regulations, 48 CFR 31.201-3(a) , state that a cost is reasonable if it does not exceed that which would be incurred by a prudent person in the conduct of a competitive business. We believe that BCBSM'S salary increases of approximately 40 percent for eleven executives is unreasonable because the applicable ECI for the same period was only 10.32 percent. Total increases in excess of the ECI were about \$1.3 million. During FY 1991 through 1993, the Medicare program was allocated \$149,049-of the \$1.3 million.

#### Recommendations

We recommend that BCBSM make a financial adjustment of \$149,049, as follows:

	<u>Part A</u>	<u>Part B</u>	<u>Total</u>
FY 1993	\$10,605	\$ 36,837	\$ 47,442
FY 1992	9,090	35,556	44,646
FY 1991	<u>11,367</u>	<u>45,594</u>	<u>56,961</u>
	<u>\$31,062</u>	<u>\$117,987</u>	<u>\$149,049</u>

#### Auditee Comments

BCBSM disagreed with our finding. They contend that the method we used to determine reasonableness conflicts with the FAR. They believe the ECI is a general private industry index that does not adequately account for the particulars of the non-profit insurance carrier industry. BCBSM contends that they benchmark executive pay against comparable companies before Board approval is granted and that during 1990 through 1993, BCBSM executive pay was below the average for comparable companies. Moreover, it is their understanding the audit did not account for promotions which they believe should not be included in the calculation of salary increases .

#### OIG Response

We believe that the ECI components relate to the factors of reasonableness listed in the FAR. However, 48 CFR 31.205-6(b) (1) places the burden for demonstrating the reasonableness of salary increases on BCBSM. The BCBSM could not provide any documentation that demonstrated the salary increases were reasonable. Although the executive salary increases were approved by BCBSM'S Board of Directors, the minutes of those meetings provide no evidence to support the reasonableness of the increases.

With respect to BCBSM'S concern about position changes and promotions, our calculations included only the compensation to eleven executives that retained the same position throughout our

audit period. In our opinion, the ECI demonstrates that the salary increases in excess of 40% that were paid to BCBSM executives are unreasonable.

**SPECIAL EARLY RETIREMENT PROGRAM.** BCBSM claimed unallowable pension costs of \$109,988 pertaining to a Special Early Retirement Program (SERP). In 1988, BCBSM amended its pension plans with a SERP. Our prior audit of BCBSM's pension plans (CIN: A-07-92-00525) determined that the SERP costs were not computed or funded in accordance with the applicable Federal regulations and were unallowable for Medicare reimbursement. In response to our prior audit, BCBSM concurred in our findings and recommendations. During our current audit, BCBSM provided no additional evidence to support that anything has changed with respect to the allowability of these costs. Therefore, we are disallowing the \$109,988.

#### Recommendations

We recommend that BCBSM make a financial adjustment of \$109,988, as follows:

	<u>Part A</u>	<u>Part B</u>	<u>Total</u>
FY 1990	<u>\$25,579</u>	<u>\$84,409</u>	<u>\$109,988</u>

#### Auditee Comments

The Auditee stated that they are presently reviewing the matter and will respond to our finding when they can do so on a fully informed basis.

#### OIG Response

During our audit field work, we requested and examined all available information provided by BCBSM. Subsequent to the issuance of the draft report and again at the exit conference, OIG auditors were available to answer questions and share information. BCBSM officials never requested any additional information or clarification. Accordingly, we continue to recommend that BCBSM make the appropriate financial adjustment as reported.

**EXECUTIVE INCENTIVE AWARDS.** Medicare costs for executive bonuses were overstated by \$23,957 as a result of a distribution that was inconsistent with its allocation plan and the allocation used for other executive costs. BCBSM's allocation plan states that any manager responsible for more than one cost center is assigned to a separate cost center and manager's costs are allocated based on the

cost centers supervised. Our review showed that except for incentive compensation, executive costs were allocated in accordance with this established allocation plan. We also noted that executive incentive awards were allocated to all lines of business through the Human Resources cost center. This was inconsistent with the normal distribution of the executive costs and did not result in an equitable allocation to the benefiting activities. We identified the regularly assigned cost centers for each executive and redistributed the incentive compensation. Based on our redistribution we determined that Medicare was overcharged by \$23,957.

### Recommendations

We recommend that BCBSM make a financial adjustment of \$23,957, as follows:

	<u>Part A</u>	<u>Part B</u>	<u>Total</u>
FY 1993	\$ (166)	\$ 9,882	\$ 9,716
FY 1992	4,844	3,035	7,879
FY 1991	(197)	(1,776)	(1,973)
FY 1990	<u>1,640</u>	<u>6,695</u>	<u>8,335</u>
	<u>\$6,121</u>	<u>\$17,836</u>	<u>\$23,957</u>

### Auditee Comments

BCBSM did not concur with our findings and recommendations. Specific comments provide that the activities performed by executives are for the benefit of the organization taken as a whole. Therefore, the allocation of all executives' incentive awards to all activities is appropriate.

### OIG Response

BCBSM's allocation of incentive compensation is inconsistent with the normal distribution of the executives' costs. Except for incentive compensation, BCBSM allocated executive salaries and all other costs through assigned costs centers based on cost studies of specific benefiting activities. For example, BCBSM determined that the executive salaries and other costs relating to its largest accounts (automobile companies) do not benefit Medicare and, therefore, were not allocated to the Medicare program. However, incentive awards to executives overseeing these accounts were allocated to Medicare. Since BCBSM determined that the regular activities of these executives did not benefit Medicare, incentive awards based on the executives performance should not have been allocated to Medicare.



**EXHIBITS**

EXHIBIT A

BLUE CROSS AND BLUE SHIELD OF MICHIGAN  
 MEDICARE PART A FINAL ADMINISTRATIVE COST PROPOSAL AND  
 THE AUDITORS' RECOMMENDATIONS  
 FOR THE FISCAL YEARS 1990 THROUGH 1993

<u>Operation</u>	<u>Administrative costs</u>
Bills Payment	\$28,241,222
Reconsiderations & Hearings	1,092,260
Medicare Secondary Payer	6,620,919
Medical Review & Utilization Review	3,692,370
Provider Desk Reviews	4,023,277
Provider Field Audits	8,843,707
Provider Settlements	4,216,612
Provider Reimbursement	4,095,846
Productivity Investments	1,026,305
Fraud and Abuse	176,936
Other	<u>1,265,160</u>
Total Administrative Costs Claimed	<u>\$63,294,614</u>
Costs Recommended for Acceptance	<u>\$57,964,281</u>
Recommended Financial Adjustment	<u>\$5,330,333</u>

**BREAKOUT OF RECOMMENDED FINANCIAL ADJUSTMENT**

Costs Claimed in Excess of the NOBA	\$1,955,085
Unallowable Costs	
1. Strategic Planning	\$ 462,464
2. Complementary Credits	1,390,881
3. Productivity Investments	120,308
4. Part A Claims Processing System	1,227,107
5. Miscellaneous Income Credits	34,348
6. Miscellaneous Unallowable Costs	77,378
7. Executive Compensation	31,062
8. Special Early Retirement Program	25,579
9. Executive Incentive Awards	<u>6,121</u>
Total Unallowable Costs	<u>3,375,248</u>
Total Recommended Financial Adjustment	<u>\$5,330,333</u>

**Note:** Explanation of each adjustment is provided in the "Findings and Recommendations" section of this report.

## EXHIBIT B

BLUE CROSS AND BLUE SHIELD OF MICHIGAN  
 MEDICARE PART A FINAL ADMINISTRATIVE COST PROPOSAL AND  
 THE AUDITORS' RECOMMENDATIONS  
 FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1993

Operation	Administrative costs
Bills Payment	\$ 7,662,894
Reconsiderations & Hearings	311,213
Medicare Secondary Payer	1,676,093
Medical Review & Utilization Review	1,019,388
Provider Desk Reviews	1,319,496
Provider Field Audits	2,111,194
Provider Settlements	1,243,259
Provider Reimbursement	1,190,479
Productivity Investments	175,955
Fraud and Abuse	176,936
Other	<u>143,681</u>
Total Administrative Costs Claimed	<u>\$17,030,588</u>
Costs Recommended for Acceptance -- NOBA)	<u>\$15,952,097</u>
Recommended Financial Adjustment	<u>\$1,078,491</u>
 <b>BREAKOUT OF RECOMMENDED FINANCIAL ADJUSTMENT</b>	
Costs Claimed in Excess of the NOBA	\$ 418,315
 <b>Unallowable Costs</b>	
1. Strategic Planning	\$ 143,770
2. Complementary Credits	361,152
3. Productivity Investments	62,855
4. Miscellaneous Income Credits	20,443
5. Miscellaneous Unallowable Costs	61,517
6. Executive Compensation	10,605
7. Executive Incentive Awards	<u>(166)</u>
Total Unallowable costs	<u>660,176</u>
Total Recommended Financial Adjustment	<u>\$1,078,491</u>

**Note:** Explanation of each adjustment is provided in the "Findings and Recommendations" section of this report.

BLUE CROSS AND BLUE SHIELD OF MICHIGAN  
 MEDICARE PART A FINAL ADMINISTRATIVE COST PROPOSAL AND  
 THE AUDITORS' RECOMMENDATIONS  
 FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1992

Operation	Administrative costs
Bills Payment	\$ 7,770,072
Reconsiderations & Hearings	264,668
Medicare Secondary Payer	1,688,581
Medical Review & Utilization Review	761,341
Provider Desk Reviews	986,131
Provider Field Audits	2,000,144
Provider Settlements	950,423
Provider Reimbursement	954,825
Productivity Investments	<u>329,429</u>
Total Administrative Costs Claimed	<u>\$15,705,614</u>
Costs Recommended for Acceptance -- (NOBA)	<u>\$14,058,020</u>
Recommended Financial Adjustment	<u>\$1,647,594</u>
BREAKOUT OF RECOMMENDED FINANCIAL ADJUSTMENT	
Costs Claimed in Excess of the NOBA	\$1,098,140
Unallowable Costs	
1. Strategic Planning	172,666
2. Complementary Credits	341,008
3. Miscellaneous Income Credits	14,256
4. Miscellaneous Unallowable Costs	7,590
5. Executive Compensation	9,090
6. Executive Incentive Awards	<u>4,844</u>
Total Unallowable Costs	<u>549,454</u>
Total Recommended Financial Adjustment	<u>\$1,647,594</u>

Note: Explanation of each adjustment is provided in the "Findings and Recommendations" section of this report.

BLUE CROSS AND BLUE SHIELD OF MICHIGAN  
 MEDICARE PART A FINAL ADMINISTRATIVE COST PROPOSAL AND  
 THE AUDITORS' RECOMMENDATIONS  
 FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1991

Operation	Administrative costs
Bills Payment	\$ 6,720,242
Reconsiderations & Hearings	235,261
Medicare Secondary Payer	1,797,763
Medical Review & Utilization Review	946,347
Provider Desk Reviews	696,760
Provider Field Audits	2,583,185
Provider Settlements	804,265
Provider Reimbursement	986,823
Productivity Investments	<u>225,368</u>
Total Administrative Costs Claimed	<u>\$14,996,014</u>
Costs Recommended for Acceptance	<u>\$13,924,500</u>
Recommended Financial Adjustment	<u><u>\$1,071,514</u></u>
<b>BREAKOUT OF RECOMMENDED FINANCIAL ADJUSTMENT</b>	
Costs Claimed in Excess of the NOBA	\$ 438,630
<b>Unallowable Costs</b>	
1. Strategic Planning	\$ 81,811
2. Complementary Credits	405,630
3. Productivity Investments	43,100
4. Part A Claims Processing System	86,878
5. Miscellaneous Income Credits	(2,222)
6. Miscellaneous Unallowable Costs	6,517
7. Executive Compensation	11,367
8. Executive Incentive Awards	<u>(197)</u>
Total Unallowable Costs	<u>632,884</u>
Total Recommended Financial Adjustment	<u><u>\$1,071,514</u></u>

**Note:** Explanation of each adjustment is provided in the "Findings and Recommendations" section of this report.

## EXHIBIT E

**BLUE CROSS AND BLUE SHIELD OF MICHIGAN**  
**MEDICARE PART A FINAL ADMINISTRATIVE COST PROPOSAL AND**  
**THE AUDITORS' RECOMMENDATIONS**  
**FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1990**

<u>Operation</u>	<u>Administrative costs</u>
Bills Payment	\$ 6,088,014
Reconsiderations & Hearings	281,118
Medicare Secondary Payer	1,458,482
Medical Review & Utilization Review	965,294
Provider Desk Reviews	1,020,890
Provider Field Audits	2,149,184
Provider Settlements	1,218,665
Provider Reimbursement	963,719
Productivity Investments	295,553
Other - Part A Systems	<u>1,121,479</u>
Total Administrative Costs Claimed	<u>\$15,562,398</u>
Costs Recommended for Acceptance	<u>\$14,029,664</u>
Recommended Financial Adjustment	<u>\$1,532,734</u>
<b>BREAKOUT OF RECOMMENDED FINANCIAL ADJUSTMENT</b>	
costs Claimed in Excess of the NOBA	\$ 0
Less : Unallowable Costs	
1. Strategic Planning	\$ 64,217
2. Complementary Credits	283,091
3. Productivity Investments	14,353
4. Part A Claims Processing System	1,140,229
5. Miscellaneous Income Credits	1,871
6. Special Early Retirement Program	25,579
7. Miscellaneous Unallowable Costs	1,754
8. Executive Incentive Awards	<u>1,640</u>
Total Unallowable costs	<u>1,532,734</u>
Total Recommended Financial Adjustment	<u>\$1,532,734</u>

Note: Explanation of each adjustment is provided in the "Findings and Recommendations" section of this report.

EXHIBIT F

BLUE CROSS AND BLUE SHIELD OF MICHIGAN  
 MEDICARE PART B FINAL ADMINISTRATIVE COST PROPOSAL AND  
 THE AUDITORS' RECOMMENDATIONS  
 FOR THE FISCAL YEARS 1990 THROUGH 1993

<u>Operation</u>	<u>Administrative costs</u>
Claims Payment	\$ 96,760,921
Reviews & Hearings	13,999,748
Beneficiary/Physician Inquiry	20,043,160
Professional Relations	1,563,739
Provider Education & Training	617,054
Medical Review & Utilization Review	15,987,618
Medicare Secondary Payer	4,571,056
Participating Physicians	2,592,803
Productive-ty Investments	5,866,083
Fraud and Abuse	1,719,824
CWF - Satellite	52,100
Other	<u>1,070,970</u>
<b>Total Administrative Costs Claimed</b>	<u>\$164,845,076</u>
Costs Recommended for Acceptance	<u>\$154,565,691</u>
Recommended Financial Adjustments	<u>\$10,279,385</u>
<b>BREAKOUT OF RECOMMENDED FINANCIAL ADJUSTMENT</b>	
Costs Claimed in Excess of the NOBA	\$ 6,096,165
<b>Unallowable Costs</b>	
1. Strategic Planning	\$1,899,400
2. Complementary Credits	665,407
3. Productivity Investments	1,197,988
4. Miscellaneous Income Credits	125,212
5. Miscellaneous Unallowable Costs	74,981
6. Executive Compensation	117,987
7. Special Early Retirement Program	84,409
8. Executive Incentive Awards	<u>17,836</u>
Total Unallowable Cost	<u>4,183,220</u>
Total Recommended Financial Adjustment	<u>\$ 10,279,385</u>

Note: Explanation of each adjustment is provided in the "Findings and Recommendations" section of this report.

## EXHIBIT G

BLUE CROSS AND BLUE SHIELD OF MICHIGAN  
 MEDICARE PART B FINAL ADMINISTRATIVE COST PROPOSAL AND  
 THE AUDITORS' RECOMMENDATIONS  
 FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1993

Operation	Administrative costs
Claims Payment	\$22,901,497
Reviews & Hearings	3,788,052
Beneficiary/Physician Inquiry	6,250,250
Provider Education & Training	617,054
Medical Review & Utilization Review	3,656,554
Medicare Secondary Payer	1,392,391
Participating Physicians	475,486
Productivity Investments	504,430
Fraud and Abuse	1,719,824
Other	<u>701,270</u>
Total Administrative Costs Claimed	<u>\$42,006,808</u>
Costs Recommended for Acceptance -- (NOBA)	<u>\$39,926,050</u>
Recommended Financial Adjustment	<u>\$2,080,758</u>
<b>BREAKOUT OF RECOMMENDED FINANCIAL ADJUSTMENT</b>	
Costs Claimed In Excess of the NOBA	\$1,220,904
Unallowable Costs	
1. Strategic Planning	594,790
2. Complementary Credits	178,375
3. Miscellaneous Income Credits	17,154
4. Miscellaneous Unallowable Costs	22,816
5. Executive Compensation	36,837
6. Executive Incentive Awards	<u>9,882</u>
Total Unallowable Costs	<u>859,854</u>
Total Recommended Financial Adjustment	<u>\$2,080,758</u>

**Note:** Explanation of each adjustment is provided in the " Findings and Recommendations " section of this report.



## EXHIBIT H

BLUE CROSS AND BLUE SHIELD OF MICHIGAN  
 MEDICARE PART B FINAL ADMINISTRATIVE COST PROPOSAL AND  
 THE AUDITORS' RECOMMENDATIONS  
 FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1992

Operation	Administrative costs
Claims Payment	\$25,765,146
Reviews & Hearings	3,462,333
Beneficiary/Physician Inquiry	6,363,775
Professional Relations	683,506
Medical Review & Utilization Review	4,478,325
Medicare Secondary Payer	1,382,109
Participating Physicians	536,945
Productivity Investments	1,446,433
Other	<u>286,000</u>
 Total Administrative Costs Claimed	 <u>\$44,404,572</u>
 Costs Recommended for Acceptance -- (NOBA)	 <u>\$39,411,200</u>
 Recommended Financial Adjustment	 <u>\$4,993,372</u>
 BREAKOUT OF RECOMMENDED FINANCIAL ADJUSTMENT	
 Costs Claimed in Excess of the NOBA	 \$3,835,681
 Unallowable Costs	
1. Strategic Planning	699,004
2. Complementary Credits	206,253
3. Productivity Investments	167,576
4. Miscellaneous Income Credits	20,689
5. Miscellaneous Unallowable Costs	25,578
6. Executive Compensation	35,556
7. Executive Incentive Awards	<u>3,035</u>
 Total Unallowable Costs	 <u>1,157,691</u>
 Total Recommended Financial Adjustment	 <u>\$4,993,372</u>

**Note:** Explanation of each adjustment is provided in the " Findings and Recommendations " section of this report.

## EXHIBIT I

**BLUE CROSS AND BLUE SHIELD OF MICHIGAN  
 MEDICARE PART B FINAL ADMINISTRATIVE COST PROPOSAL AND  
 THE AUDITORS' RECOMMENDATIONS  
 FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1991**

<u>Operation</u>	<u>Administrative costs</u>
Claims Payment	\$ 25,354,235
Reviews & Hearings	3,766,578
Beneficiary/Physician Inquiry	4,342,530
Professional Relations	551,378
Medical Review & Utilization Review	4,191,926
Medicare Secondary Payer	965,523
Participating Physicians	844,313
Productivity Investments	631,855
Other	<u>83,700</u>
Total Administrative Costs Claimed	<u>\$40,732,038</u>
Costs Recommended for Financial Adjustment - (NOBA)	<u>\$38,864,500</u>
Recommended Financial Adjustment	<u>\$1,867,538</u>
<b>BREAKOUT OF RECOMMENDED FINANCIAL ADJUSTMENT</b>	
Costs Claimed in Excess of the NOBA	<b>\$1,039,580</b>
Unallowable Costs	
1. Strategic Planning	338,204
2. Complementary Credits	152,070
3. Productivity Investments	204,034
4. Miscellaneous Income Credits	68,574
5. Miscellaneous Unallowable Costs	21,258
6. Executive Compensation	45,594
7. Executive Incentive Awards	<u>(1,776)</u>
Total Unallowable Costs	<u>827,958</u>
Total Recommended Financial Adjustment	<u>\$1,867,538</u>

Note: Explanation of each adjustment is provided in the "Findings and Recommendations" section of this report.

BLUE CROSS AND BLUE SHIELD OF MICHIGAN  
 MEDICARE PART B FINAL ADMINISTRATIVE COST PROPOSAL AND  
 THE AUDITORS' RECOMMENDATIONS  
 FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1990

Operation	Administrative costs
Claims Payment	\$22,740,043
Reviews & Hearings	2,982,785
Beneficiary/Physician Inquiry	3,086,605
Professional Relations	328,855
Medical Review & Utilization Review	3,660,813
Medicare Secondary Payer	831,033
Participating Physicians	736,059
Productivity Investments	3,283,365
CWF - Satellite	<u>52,100</u>
<b>Total Administrative Costs Claimed</b>	<u><b>\$37,701,658</b></u>
<b>Costs Recommended For Acceptance</b>	<u><b>\$36,363,941</b></u>
<b>Recommended Financial Adjustment</b>	<u><b>\$ 1,337,717</b></u>
 <b>BREAKOUT OF RECOMMENDED FINANCIAL ADJUSTMENT</b>	
Costs Claimed in Excess of the NOBA	\$ 0
Unallowable Costs	
1. Strategic Planning	267,402
2. Complementary Credits	128,709
3. Productivity Investments	826,378
4. Miscellaneous Income Credits	18,795
5. Miscellaneous Unallowable Costs	5,329
6. Special Early Retirement Program	84,409
7. Executive Incentive Awards	<u>6,695</u>
<b>Total Unallowable Costs</b>	<u><b>1,337,717</b></u>
<b>Total Recommended Financial Adjustment</b>	<u><b>\$ 1,337,717</b></u>

Note: Explanation of each adjustment is provided in the "Findings and Recommendations" section of this report.

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## APPENDIX



Mark R. Bartlett, CPA, CPCU  
Vice President and Controller

600 Lafayette East  
Detroit, Michigan 48226-2996

December 7, 1995

Common Identification No. A-05094-00064

Mr. Paul Swanson  
Regional Inspector General for Audit Services  
101 W. Adams St.  
23rd Floor  
Chicago, Illinois 60603-6201

Dear Mr. Swanson:

Please find attached BCBSM's response to OIG's request for comments on its draft report entitled "AUDIT OF ADMINISTRATIVE COSTS CLAIMED UNDER PARTS A AND B OF THE HEALTH INS WCE FOR THE AGED AND DISABLED PROGRAM FOR FISCAL YEARS 1990 THROUGH 1993" ("Draft Audit Report"). BCBSM's comments are organized to address OIG's audit findings in the order in which they appear in the Draft Audit Report.

BCBSM had requested additional time to prepare its response on a fully informed basis. This request was not granted in full. Consequently, this document sets forth only BCBSM's preliminary comments, submitted for the purpose of meeting an **OIG-imposed** deadline for comments on its draft and to facilitate the settlement of disputed cost claims. We have deferred commenting upon **two** issues, Medicare Part A Claims Processing System and Special Early Retirement **Program**, as we are still in the very preliminary stages of obtaining and reviewing information concerning these items. BCBSM generally contests **all** of the **Draft** Audit Report's disallowance of **costs**, except where we have expressly stated that BCBSM will not contest an item. Please understand that any BCBSM statement that it will not contest an item is based solely upon information available to and considered by us at this time and is intended to be construed as an offer to settle by crediting HCFA with such amounts, provided that such credit is made a part of a global settlement of all of the parties' cost claims relating to our Medicare contracts. BCBSM reserves the right to submit additional information and argument and alternative bases for challenging the audit results reflected in the Draft Audit Report.

Please contact me at 313-225-6922 if you have any questions

Sincerely,

A handwritten signature in black ink that reads "Mark R. Bartlett" with a small "(V.K.)" written below the name.

Mark R. Bartlett

MRB:ct

cc: R. Naftaly

L. DeMoss

A. Peters

s. Slamar

Associate Regional Administrator, Division of Medicare

*Issue 1 Administration costs challenged based on NOBAs*

The Draft Audit Report challenges \$8,051,250 of administrative costs incurred by BCBSM, on the sole ground that such costs allegedly may not be **recovered because they exceed** HCFA'S Notice of Budget Approval (NOBA) issued for the open contract **years** covered by **the** audit. BCBSM submits that the NOBAs do not constitute a bar to recovery under its Medicare **contracts**. Consequently, consistent with the **cost** reimbursement basis of these contracts, HCFA **should reimburse fully the otherwise allowable** administrative rests claimed by **BCBSM**.

**The** fundamental basis of the bargain upon which HCFA engaged BCBSM'S **Medicare services** was cost reimbursement:

It is the intent of this contract that the Carrier, in performing its **functions** under this **contract**, shall be **paid** its cost of administration under the **principle** of neither **profit** nor **loss** to the Carrier. . .

Article XIII (A) (Article XV (A)) (emphasis added).<sup>1</sup> This **principle is made subject to certain funding** procedures in Article VI (Article XVI) of the Medicare contracts, which include the budgeting process pursuant to which NOBAs are issued. Article VI(C) (Article XVI(C)) provides, in essence, that costs in excess of then-available **funds** maybe carried forward and may exceed the NOBA with either the prior approval of HCFA or as set forth in "paragraph I." Similarly, Article VI(G) (Article XVI(G)) provides essentially **that**, while a Carrier is not obligated to continue performance **or** otherwise incur eats in excess of the **funding** deemed available by **HCFA**, "if (**excess**) costs . . . are **in fact incurred by the Plan, its right to claim such costs** under paragraph I will not be prejudiced thereby." Paragraph I states:

If the amount of **costs** incurred by the Plan which are determined to be allowable upon final settlement exceeds the budgeted **amount**, the secretary shall pay **such costs provided that the requirements of paragraph H have been met by the Plan, and provided further that funds are** available to the Secretary for Intermediary and Carrier administration. (emphasis added).<sup>2</sup>

<sup>1</sup> "Article \_\_\_\_\_" is a **citation to BCBSM'S Medicare Part A contract**; bracketed **citations** refer to the corresponding provisions of BCBSM'S **Medicare Part B contract**.

<sup>2</sup> Paragraph H provides, in pertinent **part**, that "if at any time" it appears to the Carrier that the approved budget amount(s) will not be sufficient to cover administrative costs the Carrier shall so notify HCFA 60 days before the date *on* which it is estimated such amounts **will** be exhausted - unless such advance notice **could** not have been provided. Article VI(B) [Article XVI(B)] also provides that the contractor "may at anytime submit appropriate amendments to [its annual] budget which reflect modifications **in** its cost estimates."

In accordance with these Medicare contracts, BCBSM is entitled to reimbursement of its actual administrative costs. At the outset of each contract year, BCBSM provided HCFA with a requested budget for administrative costs. This process, including BCBSM's periodic provision to HCFA of cost reports and data to HCFA, provided HCFA with ample and timely notice that its Medicare contract administrative costs would exceed the NOBA which HCFA sought to establish and that additional funds were needed to reimburse the actual costs of contract performance. HCFA nonetheless required BCBSM to proceed under NOBAs that HCFA knew or should have known would not comply with the contracts' assurance that administrative costs would be reimbursed under the principle that a Carrier would operate without loss. Where, as here, HCFA requested and accepted the benefit of services to be performed on cost-reimbursement basis, with knowledge that actual costs would exceed funding limits, the contract ceiling should be adjusted upward to reimburse fully the costs of contract performance.<sup>3</sup>

In sum, BCBSM complied with the Medicare contracts' paragraph H and other provisions concerning reimbursement of its allowable administrative costs in excess of NOBAs. Further, HCFA required BCBSM to perform and accepted the benefits of BCBSM's services, knowing that administrative costs would exceed the NOBAs issued by HCFA. Accordingly, under the circumstances of this case, BCBSM is entitled to recover its allowable costs notwithstanding HCFA's failure to adjust the NOBAs required to comply with the principle of cost reimbursement governing BCBSM's Medicare contracts.

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<sup>3</sup> see seam. Inc., DOTCAB No. 1686,86-2 BCA { 18,933 (adjustment increasing contract ceding due where modification was ordered with knowledge that provisional billing rates did not reflect actual overhead rates being experienced); Recon Systems, Inc., IBCA No. 1214-9-78, 80-1 BCA { 14,425 (limitation of costs clause did not bar recovery because government issued tasks while on notice that contract funds were inadequate to reimburse costs). In some instances - particularly with respect to changes in BCBSM'S performance directed by HCFA (e.g., with regard to productivity improvements) - BCBSM, through no fault of its own was not in a position to know and thus provide HCFA with notice that costs would exceed a NOBA or other line time funding limit before BCBSM incurred or became committed to incur such costs. Under these circumstances as well, HCFA is obligated to fund the reimbursement of BCBSM's actual costs of performance. See General Electric Co. v. United States, 440 F.2d 420 (Ct. Cl. 1971) (contracting officer did not have discretion of refuse contractor additional funding on account of cost overrun, despite contractor's failure to give prior notice, where contractor, without fault, could not have known of overrun in time to give notice and government accepted performance).

*Issue 2 Strategic Planning*

The OIG has questioned a portion of the strategic planning costs incurred by the Government Business Group. The OIG stated that the costs should be **allocated** to the entire **BCBSM** organization not just to the GBG.

**Organization Defined**

The operating units of Blue Cross Blue Shield of Michigan were organized by customer **during** the fiscal years 1990 through 1993. A separate business unit was created for **federal** government contracts, the government business group (**GBG**). During the years under review, there were three **contracts** operating within the GBG; Medicare Part A and Part B and the Federal Employee Plan (**FEP**).

GBG meets the definition of a business unit provided in CAS 410:

CAS 410-30 (2) *Business unit* means any segment of an organization or an **entire** business organization which is not divided into segments.

The GBG is a business unit. There are no **further** divisions or segments of business operating within this organization.

**G & A Costs Identified**

In CAS 410-30(6) General and Administrative (G& A) **expense means** any **management**, financial and other expense which is incurred by or **allocated** to a business unit and which is for the general management and **administration** of the business unit as a whole. 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 purpose of the GBG administrative function was to manage and maintain the government contracts. During the operational phase of the contract, it was imperative that the contractor maintain a high degree of cost and operational efficiency to maintain the contract. BCBSM was searching for new methods and procedures to update the Medicare Processing system and to obtain additional government contracts for BCBSM such as the CHAMPUS contract for Region V. They were looking for ways to grow the GBG organization. If the business unit was to become larger, HCFA's share of the overhead burden would have been reduced. In the long term, all these activities would have benefited the business unit as a whole and the business unit's customers, HCFA and the OPM.

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The strategic planning department of the GBG (which reported directly to the VP of Government operations) was responsible for performing all of these economic planning activities. The specific activities this organization participated in included:

- preparation of Medicare procedure manuals
- more efficient Medicare business operations
- study to evaluate current Medicare procedures
- other miscellaneous activities to support the *Government Business Group*

The activities performed by the strategic planning group are identified as allowable costs in FAR 31.205-12 **Economic Planning costs:**

- (a) **This** category includes the costs of **generalized long** range management planning that is concerned with the future overall development of the contractor's business and that may take into account the eventual possibility of economic dislocations or **fundamental** alterations in the markets in which the contractor currently does business.

The FAR reference clearly establishes the allowability of the general **and administrative** activities of the strategic planning group.

#### Allocation Regulations

#### CAS 410 Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives

provides criteria for the allocation of business unit general and administrative expenses to **business** unit **final** cost objectives based on their beneficial or causal relationship. These expenses represent the cost of the management and administration of the business unit as a **whole**. A beneficial causal relationship exists **between** the strategic planning activities **and** the GBG. **All** GBG products will benefit **from** the work that is **performed** by the group. This benefit will be in the form of a more efficient organization following the updated methodologies and procedures, and lower overhead **costs** resulting **from** a bigger base of contracts to absorb the overhead expense.

Since the processes in issue are unique to the government business environment, no other BCBSM product would benefit from the general and administrative expenses incurred by the GBG. Therefore, the costs incurred by employees providing strategic planning for the group would only benefit the government contracts. GBG should absorb the costs for this activity. Therefore, an allocation base similar to the GBG Vice President's cost center allocation base was used to allocate the strategic planning cost center.

#### Conclusion

The GBG incurs general and administrative **costs** to manage the operations of the business unit. One of the **G & A functions was the strategic** planning operation. The costs incurred by this cost center are allowable and allocable only to the GBG organization. Therefore, we disagree with the auditors' recommendation that the costs be allocated to the entire **BCBSM** organization.

Issue 3            Complementary Credits

The Draft Audit Report takes the position that the MSP cost center should be included in the calculation of the complementary insurance credit.

Articles XXIII and XVIII of the Medicare Part A and Part B contracts provide guidance on the treatment of Carriers' complementary insurance claims process. Carriers complementary insurance process may be integrated with its Medicare claims insurance process. All direct costs shall be charged to the appropriate line of business and indirect costs shall be prorated on appropriate allocation bases consistent with the Carrier's established principles of allocating indirect costs as stipulated in Article XV B. A cost center must be allocated if the activity in the cost center benefits both the Medicare and the complementary claims process.

Only limited guidance was available on this issue during the contract years under review (1990 through 1993). Therefore, in accordance with the contracts' provision that "a cost center must be allocated if the activity in the cost center benefits both the Medicare and the complementary claims process", BCBSM did not include the MSP cost center in the complementary credit calculation. The MSP activity is designed to determine the coverage exposure of the government only and does not add value to the processing of the complementary claim. BCBSM's Regular Business Division has a separate Coordination of Benefits area to review and determine BCBSM's liability in regards to co-insurance cases. BCBSM'S complementary credit calculation has consistently followed this methodology which has been approved by HCFA in prior audits.

During Fiscal Year 1994, a study **was prepared** by BCBSM to review the process of determining the complementary credit. **In** order to **analyze the impact** of the inclusion or exclusion of **cost** centers in the **calculation**, several scenarios were **presented**. **Although the MSP cost center** was included in the final scenario, **further** analysis revealed that MSP did not benefit the **complementary** claims process. It was during this time that the contract was terminated. If the contract had been **renewed**, the study would have been amended to exclude the MSP **cost** center. Also, it should be noted that the study **focused** on cost center activities and organization as of fiscal year 1994. Therefore, the findings of the study would not have been retroactively applicable because the **functionality** of the areas in question did not change until Fiscal Year 1994

Accordingly, **BCBSM** disagrees with the auditors that the activities of the MSP cost center benefited the complementary insurance process and should have been included with the complementary insurance credit

*Issue 4            Productivity Investments*

The Draft Audit Report challenges \$1,328,296 of Productivity Investment (**PI**) **costs** incurred by **BCBSM** on the ground that **such costs allegedly may not be reimbursed because they exceed NOBAs**. **BCBSM contends that** it is entitled to **recover all PI costs notwithstanding the NOBA issue raked** by the report.

For the reasons set forth in the above section of this memorandum concerning NOBAs **generally**, **BCBSM** is entitled to recover reimbursement of otherwise allowable costs that it has claimed under its Medicare contracts. Proper **performance** of the Medicare contracts required **BCBSM** to implement such productivity improvement programs. **BCBSM** provided HCFA with timely and sufficient notice of projected and incurred **PI costs** and requested that HCFA provide adequate funding thereof. Further, to a substantial **extent**, HCFA'S acts and omissions pertaining to the implementation of these programs changed

BCBSM'S scope of work and processes, causing unpredictable variations in costs. To the extent possible, BCBSM also reported these variances to HCFA and requested finding thereof. It follows that BCBSM is entitled to an adjustment allowing recovery of its PI costs where, as here, otherwise allowable PI costs were incurred by it as required by HCFA for continued performance of the Medicare contracts, - with prior notice, to the extent possible, of the costs thereof relative to NOBAs that HCFA had issued -- and the benefits thereof were accepted by HCFA.<sup>4</sup>

*Issue 5 Medicare Part A Claims System*

BCBSM is presently reviewing this matter and will respond to **OIG's findings** when we can do so on a **fully** informed basis

*Issue 6 Miscellaneous Income Credits*

BCBSM does not contest this finding. As stated in the cover memo, any BCBSM statement that it will not contest an item is based solely upon information available to and considered by us at this time and is intended to be construed as an offer to settle by crediting HCFA with such amounts, provided that such credit is made a part of a global settlement of all of the parties' cost claims relating to our Medicare contracts.

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<sup>4</sup> see Seato, Inc., supra, Recon Systems, Inc., sums. It appears that to a substantial extent, PI costs exceeded NOBAs or individual line item budgets because of changes in BCBSM's performance necessitated by HCFA acts or omissions with respect to PI implementation. As a result, in some instances, BCBSM, through no fault of its own, was not in a position to know and provide HCFA with notice that costs would exceed a NOBA or other line item funding limit before BCBSM incurred or became committed to incur such costs. HCFA accepted the benefits of such PI costs. Under these circumstances, HCFA is obligated to fund the reimbursement of BCBSM's actual costs of performance. See General Electric Co. v. United States, supra. Further, even assuming, for argument purposes only, that HCFA would not agree that the PI NOBAs should be increased based on the grounds set forth above, BCBSM nonetheless would be entitled to recover challenged PI costs, to the extent that the Draft Audit Report fails to account for the availability of other line items' unused budget authority that could be shifted to the PI line to effectively increase the budget and thus cost recovery due BCBSM for PI costs. BCBSM estimates that approximately \$500,000 or more should be deemed available to increase the NOBA on the basis of this unused budget shifting authority.

*Issue 7            Miscellaneous Unallowable Costs*

BCBSM does not contest this finding. As stated in the cover memo, any **BCBSM** statement that it will not contest an item is based solely upon information available **to and** considered by us at this time and is intended to be construed as an offer to settle by crediting HCFA with **such amounts, provided that such** credit is made a part of a global settlement of all of the parties' cost **claims** relating to our Medicare mm-acts.

*Issue 8            Executive Compensation*

The **Draft** Audit Report questions the cost of *executive* compensation on the ground that *increases the* executives received allegedly were unreasonable because they exceeded the Employment Cost Index (**ECI**).

The Report's determination of unreasonableness is in direct conflict with the **FAR** criteria governing the determination of reasonableness. As stated in the **FAR 31.205-6(b)(1)**:

The compensation for personal services paid or accrued to each employee must be reasonable for the work performed. Compensation will be considered reasonable if each of the allowable elements making up the employee's compensation package is reasonable. In determining the reasonableness of individual elements for particular employees or classes of employees, consideration should be given to all potential relevant **facts**.

The cost principle goes onto **specify the criteria that should be considered when analyzing** compensation reasonableness:

Facts **which** may be relevant include general **conformity** with the compensation practices of other **firms** of the same size, the compensation practices of **other firms in the same industry**, the compensation **practices** of other firms in the same geographical area, the compensation practices of firms engaged in predominately non-government work and the cost of comparable **services** obtainable from outside sources. [emphasis added]

The Draft Audit Report fails to account for **any** of the factors **identified in the FAR** in their determination of **reasonableness**. The ECI is a general **index** for private industry. **In** order to **perform** a valid compensation study, the industry data and the company under **review** must be comparable. The Draft Audit Report erroneously relies upon a general private industry **index** instead of the particulars of the non-profit insurance carrier industry.

Further, **BCBSM** executive pay is approved by the Board of Directors **annually**. The proposed base and incentive pay is benchmarked against comparable companies before Board approval is granted. During the *years* 1990 through 1993 **BCBSM'S** **executive** base and incentive pay was below the average for comparable company's executive pay.

Moreover, during the audit years 1990 through 1993, several major changes took place within the senior management of **BCBSM**. It is our understanding that the audit did not account for position changes and promotions that took place among the executives. Promotions **should** not have been included in the calculation of salary increases. There are large variations in salaries among senior executives. **At the** senior levels, salary and incentive pay is **commensurate** with the responsibility of the position.

*Issue 9 ' Special Early Retirement Program*

**BCBSM** is **presently** reviewing this matter and will respond to **OIG's** findings when we can do so on a **fully informed** basis.

*Issue 10*

*Executive Incentive Awards*

The Draft Audit Report questions \$23,957 of the executives' incentive awards, apparently on the basis that the allocation is allegedly inconsistent with BCBSM'S allocation **plan and** the incentive awards costs should be allocated following the same method as other executive costs.

**BCBSM** allocates all incentive awards as part of the **costs** of the Human Resources cost center. The base used to allocate these awards is a surrogate allocation base comprised of all BCBSM'S employee hours. This base represents all activities, both **direct** and **indirect**, within the **BCBSM** organization.

Incentive awards are paid to reward executives for good **performance** of the entire BCBSM organization not just the GBG. Activities performed by executives are for the benefit of the organization taken as a whole. By allocating the incentive awards on the basis of employee hours, the entire organization's functions, which must all **perform** together and at an acceptable level, are part of the allocation equation.

There is no specific required methodology to follow for allocating incentive awards. If, as is the case **here**, the methodology maintains the causal and beneficial relationship of the cost and the base, it is an acceptable allocation method.

Accordingly, **BCBSM** disagrees with the Draft Audit Report's position that the costs should have been allocated following an alternative method.