



DEPARTMENT OF HEALTH & HUMAN SERVICES

REGION III
3535 MARKET STREET
PHILADELPHIA, PENNSYLVANIA 19104

TELEPHONE:
AREA CODE 215
596-6743-6744

January 30, 1996

OIG OFFICE OF AUDIT SERVICES

MAILING ADDRESS:
P.O. BOX 13716, MAIL STOP 9
PHILADELPHIA,
PENNSYLVANIA 19101

Our Reference: Common Identification Number A-03-93-00020

Mr. William L. Jews
President and CEO
Blue Cross and Blue Shield
of Maryland, Inc.
10455 Mill Run Circle
Owings Mills, Maryland 21117

Dear Mr. Jews:

Enclosed for your review and comments are two copies of an OIG audit report entitled **"REVIEW OF MEDICARE PART A ADMINISTRATIVE COSTS FOR BLUE CROSS AND BLUE SHIELD OF MARYLAND"** for Fiscal Years 1989 through 1992. Your attention is invited to the audit findings and recommendations contained in the report.

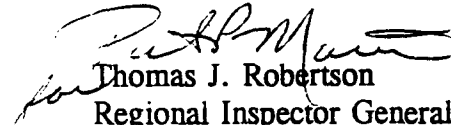
Final determination as to actions to be taken on all matters reported will be made by the HHS official named below. We request that you respond to each of the recommendations in this report within 30 days from the date of this letter to the HHS official named, presenting any comments or additional information that you believe may have a bearing on his final determination.

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), HHS/OIG Office of Audit Services reports issued to the Department's grantees and contractors are made public to the extent information contained therein is not subject to exemptions in the Act, which the Department chooses to exercise. (See Section 5.71 of the Department's Public Information Regulation, dated August 1974, as revised.)

Page 2 - Mr. William L. Jews

To facilitate identification, please refer to the above common identification number in all correspondence pertaining to this report.

Sincerely yours,


Thomas J. Robertson
Regional Inspector General
for Audit Services

Enclosure

Reply direct to:

Mr. Dennis Carroll
Associate Regional Administrator
Division of Medicare, Region III
Health Care Financing Administration
3535 Market Street
Philadelphia, Pennsylvania 19104

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF MEDICARE PART A
ADMINISTRATIVE COSTS FOR
FISCAL YEARS 1989 - 1992**

**BLUE CROSS AND BLUE SHIELD
OF MARYLAND**



JUNE GIBBS BROWN
Inspector General

JANUARY 1996
CIN: A-03-93-00020

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EXECUTIVE SUMMARY

BACKGROUND

This report addresses general administrative costs claimed by Blue Cross and Blue Shield of Maryland (BCBSM) for the administration of the Medicare Part A program for Fiscal Years (FYs) 1989 through 1992. During the review period, BCBSM claimed a total of \$26,019,364 in administrative costs.

The Medicare program is administered by the Health Care Financing Administration (HCFA) with assistance from public or private organizations known as Intermediaries. The Intermediaries are responsible for establishing safeguards against unnecessary payments, as well as the receipt, review, audit, and payment of Medicare Part A claims in designated geographical areas. The BCBSM is the Intermediary responsible for Part A claims submitted by providers of services in Maryland and the District of Columbia.

Program regulations governing the administrative costs reimbursed under the Medicare program are contained in Chapter 1, Part 31 of the Federal Acquisition Regulation (FAR), as interpreted and modified by the Medicare contracts, and the Intermediary Manual.

OBJECTIVE

The primary objective of our review was to determine whether BCBSM's costs claimed on the Final Administrative Cost Proposals (FACPs) for FYs 1989 through 1992 presented fairly the allowable costs of administration of the Part A program in conformity with reimbursement principles contained in the prescribed Federal regulations.

SUMMARY OF FINDINGS

Our review showed that BCBSM improperly allocated costs totaling \$898,627 to the Medicare program which were unallowable in accordance with applicable Federal regulations and the terms of the Medicare contract. These costs consisted of \$863,654 of unallowable costs and \$34,973 of unsupported costs.

Unallowable Costs

We identified \$863,654 that was unallowable according to Medicare guidelines. Medicare program regulations generally require that an allowable cost must be reasonable, necessary and beneficial to Medicare. These unallowable costs and the program guidelines are summarized below.

UNALLOWABLE COSTS

<u>Category of Cost</u>	<u>Amount</u>	<u>Report Page</u>
Unallowable Compensation	\$425,960	5
Lease Payments	422,584	18
Private Business Expenses	5,309	20
Charitable Contributions	1,828	20
Other Expenditures	<u>7,973</u>	20
Total	<u>\$863,654</u>	

These costs were disallowed in accordance with Medicare guidelines.

- ▶ Increases to compensation of senior executives were far in excess of the national average. Bonus and incentive payments to corporate employees were based on the profitability of BCBSM's private lines of business while payments to Medicare employees program were excessive and unreasonable charges in relation to any benefits received by Medicare.
- ▶ Rental costs under a sale and leaseback arrangement are allowable up to the amount that would have been allowed had the contractor retained title to the property.
- ▶ Consultant costs that related solely to BCBSM's private lines of business.
- ▶ Contributions or donations are prohibited under Medicare guidelines.
- ▶ Entertainment, chartered air-service, gifts, limousine services, alcohol charges and miscellaneous costs were either unallowable or not necessary for the administration of the Part A program.

Unsupported Costs

The administrative costs claimed by BCBSM included \$34,973 of costs for which the documentation supporting the expenditure was either not provided or proved inadequate to determine the nature, type, reasonableness, or necessity of the expense.

Section 1504 of the HCFA Intermediary Manual states that:

"The intermediary shall maintain books, records, documents and other evidence pertaining to the costs and expenses of the agreement....These records shall be maintained to the extent and in such detail as will properly reflect all net costs, direct and indirect...of whatever nature claimed to have been incurred, and for which reimbursement is claimed under the provisions of the agreement."

The BCBSM records did not meet this requirement.

The majority of the inadequately supported costs resulted from contractual agreements. The BCBSM was asked to provide documentation that would show the nature of the services rendered which would enable us to determine whether or not the costs were allowable and allocable to Medicare; the documentation has not been provided.

RECOMMENDATIONS

Our review of booked costs for FYs 1989 through 1992 showed that BCBSM did not adequately screen unallowable costs from being allocated to the Medicare program. As a result, BCBSM allocated unallowable and unsupported costs of \$898,627 to the program.

We, therefore, recommend that BCBSM:

1. Strengthen its cost allocation system to assure that unallowable costs, including the type identified in this report, are not allocated to the Medicare program in the future.
2. Coordinate with HCFA to reduce the costs claimed on FY 1989 through 1992 FACP's by \$863,654.
3. Provide adequate documentation for unsupported costs of \$34,973 or make the appropriate adjustment to the FACP's.

The problems noted with the Medicare costs were tempered by the fact the BCBSM did not claim all costs incurred. We noted that BCBSM arbitrarily made an adjustment of about \$2.2 million to cap costs in order to lower the cost per claim. Our recommendations for

financial adjustments must take into account the allowable costs incurred but not claimed. If HCFA decides to reimburse BCBSM based on the costs claimed on the FACPs, then our specific recommendations shown in this reports should be implemented.

On February 22, 1995, BCBSM responded to a draft of this report. In its response BCBSM disagreed with findings and recommendations related to unallowable compensation and lease payments. The BCBSM concurred with our findings on private business expenses, charitable contributions, and other miscellaneous expenditures. The BCBSM stated that documentation would be provided in order to make a determination on the unsupported costs. To date, BCBSM has not furnished any additional information to support these costs. The BCBSM response has been summarized and incorporated in this report and has been included in its entirety as Appendix A.

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INTRODUCTION

BACKGROUND

The Health Insurance for the Aged and Disabled program (Medicare), Title XVIII of the Social Security Act, provides for a hospital insurance program (Part A) and a related medical insurance program (Part B). Medicare covers: (1) eligible persons aged 65 and over; (2) disabled persons under 65 who have been entitled to Social Security or railroad retirement benefits for at least 24 consecutive months; and (3) individuals under age 65 who have chronic kidney disease and are insured by or entitled to Social Security benefits.

Medicare is administered by the Health Care Financing Administration (HCFA). Under an agreement with the Secretary of the Department of Health and Human Services (HHS), the Blue Cross Association (BCA) participates in the administration of the Medicare Part A program. Under a sub-contract with BCA, Blue Cross and Blue Shield of Maryland (BCBSM) is responsible for the receipt, review, audit, and payment of Medicare Part A claims submitted by the providers it services. The BCBSM is entitled to reimbursement for allowable administrative costs under the sub-contract.

The BCBSM is reimbursed for its costs under the terms of the contracts with HCFA under the principle of *neither profit or loss*. The BCBSM is entitled to reimbursement of all allowable costs claimed on the Final Administrative Cost Proposal (FACP), provided that the required provisions of the Medicare contract have been met. Appendix B of the contract and referenced Federal regulations identify allowable administrative costs that may be reimbursed.

From October 1, 1988 to September 30, 1992, BCBSM claimed administrative costs of \$26,019,364 for processing Medicare Part A claims in excess of \$6.4 billion. As shown below, BCBSM's claimed costs did not exceed its total approved budget in any of the 4 years under review.

COMPARISON OF CLAIMED TO BUDGETED COSTS			
<u>Fiscal Year</u>	<u>Claimed</u>	<u>Budgeted</u>	<u>Over</u>
1989	\$ 6,379,764	\$ 6,379,764	\$ -0-
1990	6,773,200	6,773,500	(300)
1991	6,797,400	6,797,400	-0-
1992	<u>6,069,000</u>	<u>6,069,000</u>	<u>-0-</u>
Total	<u>\$26,019,364</u>	<u>\$26,019,664</u>	<u>\$(300)</u>

SCOPE

Our audit was made in accordance with generally accepted government auditing standards. The primary objective was to determine whether BCBSM's Medicare Part A FACP's for Fiscal Years (FYs) 1989 through 1992 presented fairly the allowable costs of administration

in conformity with the reimbursement principles contained in Chapter 1, Part 31 of the Federal Acquisition Regulation (FAR), as interpreted and modified by the Medicare contracts, and the Intermediary Manual. We could not, however, trace specific costs that comprised amounts claimed on the FACPs to BCBSM's accounting records because BCBSM placed an arbitrary "cap" on costs charged to Medicare Part A. The purpose of the "cap" was to lower the costs per claim so that a favorable evaluation from HCFA would result. As a result of this practice, some costs, although allocated to Medicare, were not claimed on the FACPs for reimbursement.

In developing the FACPs, BCBSM allocated costs to the Medicare program and other lines of business. The booked costs, that is, the costs shown on the accounting records as allocated to Medicare, totaled \$28,527,234 for FYs 1989 through 1992. The FACPs for the same period, however, reported \$26,019,364 or \$2,507,870 less than the booked costs. The difference resulted from adjustments made by BCBSM as described below.

ADJUSTMENTS TO BOOK COSTS	
<u>Amount</u>	<u>Type of Adjustment</u>
\$ 294,220	Year-end adjustments made by the Medicare Accounting Department for costs not allowable under the Medicare Program.
1,304,173	CAP adjustments made to bring booked costs more in line with HCFA's Notice of Budget Awards (NOBA).
909,477	Adjustments for Review (AR) made at the end of the year prior to the submission of the FACP to take into account that HCFA issues several NOBAs throughout the year.
<u>\$2,507,870</u>	Total adjustments made to booked costs.

We could not identify the specific booked costs that were subject to the CAP or the AR adjustments. As a result, we audited the allowability of booked costs, less the year end adjustments, of \$28,233,014 during FYs 1989 through 1992.

As part of our audit, we reviewed BCBSM's systems of internal control for the accounting and reporting of administrative costs incurred under the program, to the extent we considered necessary, to evaluate the systems and determine compliance with contractual and administrative requirements. Such a review, however, would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of BCBSM's Medicare Part A operations taken as a whole.

Our review of BCBSM's accounting system--the Maryland Automated Cost Accounting Program (MACAP)--was limited to evaluating a review of the system conducted by a certified public accounting (CPA) firm and evaluating various reports generated specifically for the Medicare program. In 1991, BCBSM implemented an updated version of the MACAP system, known as the New Cost Accounting Program (NEWCAP). We reviewed the enhancements made to the new system and concluded that the overall control environment had not significantly changed from MACAP to NEWCAP.

Our audit included testing of BCBSM's compliance with certain provisions of laws, regulations and contractual requirements. All instances of noncompliance are discussed in the RESULTS OF AUDIT section in this report. Nothing came to our attention that would cause us to believe that untested items were not in compliance with applicable laws, regulations, and contractual requirements.

Our review focused primarily on those items which had the greatest risk of abuse or noncompliance with applicable Federal regulations. As a result, we judgementally tested expenditures from selected cost categories charged to Medicare. Based on our review of BCBSM's accounting records, we selected the following number of invoices for review:

INVOICES TESTED		
<u>Fiscal Year</u>	<u>Invoices</u>	<u>Amount</u>
1989	481	\$2,217,910
1990	242	1,315,944
1991	231	724,418
1992	<u>170</u>	<u>1,080,791</u>
Total	<u>1,124</u>	<u>\$5,339,063</u>

In reviewing the allowability and allocability of selected costs, we considered whether the costs incurred were: (1) allowable; (2) reasonable; (3) necessary to the overall operation of BCBSM; (4) a benefit to Medicare; and (5) deemed to be assignable to Medicare in view of the provisions contained in the FAR, Medicare contracts, and the Carrier Manual. In reviewing the reasonableness of costs, we considered whether or not the individuals that caused the costs to be incurred acted with due prudence in the circumstances considering their responsibilities to BCBSM, its employees, the Federal Government and the public at large.

Our review was performed during the period April 1993 to July 1994 at BCBSM's Medicare offices in Timonium and Corporate offices located in Owings Mill, Maryland.

RESULTS OF AUDIT

During the period October 1, 1988 through September 30, 1992, BCBSM claimed administrative costs totaling \$26,019,364 from booked costs of \$28,527,234. Based on the results of our review, we determined that BCBSM allocated costs totaling \$898,627 which were unallowable or unsupported in accordance with applicable Federal regulations and the terms of the Medicare contract. Of the total \$898,627 of questioned costs, our review identified \$863,654 in unallowable costs resulting from inadequate controls by BCBSM to prevent allocation of unreasonable and unallowable charges to the Medicare program, and \$34,973 in costs for which the documentation supporting the expenditures was either not provided or inadequate.

UNALLOWABLE COSTS ALLOCATED TO MEDICARE


The BCBSM needs to improve its cost screening methodology to prevent the allocation of unallowable costs to the Medicare program. The BCBSM cost accounting system captures expenditures and utilizes a full absorption costing method to allocate these costs to the various lines of business, including Medicare. However, adequate measures were not always taken to assure that only allowable costs were included in the costs allocated to Medicare.


As a result, BCBSM allocated \$863,654 in unallowable costs to the Medicare program as shown below:

- ▶ \$425,960 for unallowable compensation increases; including unreasonable performance and incentive bonus payments.
- ▶ \$422,584 in excess equipment lease payments to subsidiary corporations.
- ▶ \$5,309 for consultant costs that related solely to BCBSM's private lines of business.
- ▶ \$1,828 for charitable contributions.
- ▶ \$7,973 for other expenditures.

Unallowable Compensation Allocated to Medicare

During the review period, the Medicare Part A program was allocated \$425,960 in what we consider as unallowable compensation charges, specifically:

 \$130,919 in unreasonable executive compensation increases that far exceeded the national average; and

 \$295,041 in performance and incentive bonuses that were awarded to corporate and Medicare employees based either on the profitability of BCBSM or were excessive and unreasonable costs to the program.

Regulations to which the contractors must adhere support the position that compensation charged to Medicare must be reasonable. Section 31.205-6(b) of the FAR, which has been incorporated by specific reference in the Medicare contract, states, in part:

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

The onus, therefore, is placed on the contractor to show that compensation is reasonable. Our review of increases to executive compensation, as well as performance and incentive bonuses paid to corporate and Medicare employees during Calendar Years (CYs) 1989 through 1992 showed that the compensation was excessive, unreasonable, and therefore, an unallowable cost to Medicare.

Executive Compensation Increases

Our review showed that BCBSM awarded increases to executives that far exceeded the national average. We determined that BCBSM allocated \$130,919 of the excessive compensation to the Medicare Part A program.

During the 4-year period of our review, the average annual compensation package of 11 of the highest paid executives at BCBSM rose from \$142,197 in 1988 to \$282,753 in 1992, an increase of 98.8 percent. This increase was 84.2 percent higher than the national average as calculated by the Department of Labor's (DOL) Bureau of Labor Statistics Employment Cost Index (ECI). The increases exceeded the ECI by a total of \$2,883,287.

From 1988 through 1992, the average annual compensation paid to 11 top BCBSM executives rose 98.8 percent.

In reviewing the reasonableness of increases to executive compensation, we determined that neither HCFA nor BCBSM had a standard means for measuring the reasonableness of increases to executive compensation. We, therefore, used as a measurement of reasonableness the nationwide averages for executive and managerial employees employed in the private sector, as measured by the DOL's ECI. The ECI measures the rate of change in compensation and includes wages, salaries, and employers cost of employee benefits. The ECI uses a fixed market basket of labor--similar in concept to the Consumer Price Index's fixed market of goods and services--to measure change over time in employer costs of employing labor.

Excess Compensation Review Methodology

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

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

We compared the actual increases received by the executives to the ECI increases for each of the 4 years reviewed, and noted any excess. Not all of the executives were employed by BCBSM for the entire 4-year period of our review. Therefore, in computing increases in compensation we:

- ✓ used as the base year either the executives' actual compensation package for CY 1988, or their compensation package for a later year if not employed in CY 1988;
- ✓ used as the final year of our review either the compensation package for CY 1992, or the package for the year in which the executive was terminated, if prior to CY 1992; and
- ✓ computed the effect of the excess compensation on the Medicare program using the same cost methodology as used by BCBSM in developing the annual FACPs.


- ✓ We did not attempt to determine the reasonableness of the base year compensation packages.

We determined that all 11 executives had a portion of their compensation package allocated to Medicare. Four of these executives were eligible for increases the full 4 years of our review, that is, they were employed in the same position from CYs 1988 through 1992; one executive was eligible for increases in 3 of the 4 years; four executives were eligible for increases for 2 of the 4 years, and two executives were eligible for increases in just 1 of the 4 years.

**Compensation Increases
Compared to ECI**

Our review found that 9 of the 11 executives received increases in each of the years that they were employed (1 executive did not receive an increase in 1992). As shown below, the increases received by the executives exceeded the ECI in every year.

- ☞ In CY 1989, five executives that had a portion of their compensation package allocated to Medicare received increases that averaged 25.1 percent of their previous year's compensation package as opposed to an ECI increase of 3.5 percent. The increases ranged from 0.8 percent to 57.0 percent, and in terms of dollars, ranged from \$1,533 to \$96,526, or an average of \$46,308 per executive. The increases for four of the executives exceeded the ECI. These increases resulted in an increased Medicare allocation of \$19,850.
- ☞ In CY 1990, six executives received increases that averaged 57.7 percent of their previous year's compensation package as opposed to an ECI increase of 5.3 percent. The increases ranged from 3.7 percent to 84.2 percent, and, in terms of dollars, ranged from \$4,866 to \$312,127, or an average of \$110,956 per executive. There was only one executive whose increase did not exceed the ECI increase. This executive had received an increase of 41.9 percent in the previous year. The increases for the remaining five individuals resulted in an increased Medicare allocation of \$22,805.
- ☞ In CY 1991, nine executives received increases that averaged 25.9 percent of their previous year's compensation package as opposed to an ECI increase of 4.2 percent. The increases all exceeded the ECI and ranged from 13.3 percent to 59.6 percent, and in terms of dollars, ranged from \$15,741 to \$231,365, or an average of \$60,434 per executive. We noted that the executive that received an increase of 3.7 percent in CY 1990 received an increase of \$32,849 (23.9 percent) this year. The Medicare allocation was increased by \$48,795 as a result of these compensation increases.

 In CY 1992, eight of nine executives received increases that averaged 10.7 percent of their previous year's compensation package as opposed to an ECI increase of 1.6 percent. The increases ranged from 6.5 percent to 27.9 percent and, in terms of dollars, ranged from \$13,217 to \$78,011, or an increase of \$33,024 per executive. One executive did not receive an increase this year, however, this executive had received increases totaling 82.4 percent in the prior 3 years. These increase resulted in an increased Medicare allocation of \$39,469.

In summary, the 11 executives' compensation packages examined during the period of review went from an average base year compensation package of \$142,197 to an average compensation package of \$282,753 in the final year. This represents an average increase of 98.8 percent for the 11 executives. Examples of significant compensation increases included:

- The President and CEO of BCBSM received a compensation package valued at \$294,179 in CY 1988. In CY 1992, the package was valued at \$855,236, an increase of 190.7 percent. Had the increases been limited to the ECI, the executive would have received \$1,407,522 less over the 4-year period (CYs 1989 through 1992) and Medicare's Part A allocation would have been decreased by \$21,983.
- The General Counsel compensation package increased by over 231 percent, from \$183,739 in 1988 to approximately \$609,023 in 1992 (\$8,739 in excess compensation was allocated to Medicare Part A). Incentive and other bonuses accounted for over \$330,000 or 54 percent of the 1992 compensation.

Performance and incentive payments, as well as other bonuses accounted for a significant portion of executive compensation at BCBSM. In 1989, bonuses made up approximately 27 percent of total compensation. By 1991, bonuses accounted for over 44 percent of the executives' total compensation.

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

"Cost containment in terms of employee compensation does not appear to have been a priority among management at Blue Cross and Blue Shield of Maryland. ...the top ten executives of the Maryland plan experienced a 181-percent increase in total compensation from 1986 to 1991, while the remaining employees of the plan received only a 28-percent increase during the same five-year period."

Testimony from the Maryland Insurance Commissioner reinforced the above statement:

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

Our review confirmed the excessive compensation structure of senior executives at BCBSM, and found that significant amounts of this compensation were allocated to the Medicare contract for reimbursement. We converted the CY excessive increases to a FY basis and determined that the Medicare Part A program was allocated \$130,919 in unreasonable compensation for executive salary increases in excess of the ECI for FYs 1989 through 1992.

BCBSM Comments

In its response, BCBSM did not agree with our conclusion regarding increases in executive compensation. The BCBSM stated that the OIG's methodology for determining the reasonableness of compensation of both executives and employees was inconsistent with the applicable Federal Acquisition Regulation.

Specifically, BCBSM stated that:

1. the use of the ECI failed to meet the provisions of FAR §31.205-6(b) by not providing consideration for the compensation practices of other firms of comparable size, industry and location within the same geographical area.
2. the compensation levels used were supported by a 1990 study by a nationally known consulting firm.
3. the OIG study incorrectly included non-compensation payments to executives as part of their total compensation packages; and failed to utilize a constant set of positions and individuals throughout the analysis.

OAS Response

We believe the methodology used to compute increases in executive compensation was consistent and in compliance with the FAR. This methodology has shown that the increases in compensation for BCBSM executives were not only far in excess of the ECI, but were far in excess of any measurable standard of reasonableness.

In our opinion, the ECI is an appropriate instrument for determining the reasonableness of increases in executive's compensation. The ECI measures the rate of change in employee compensation, which includes wages, salaries, and employers' cost for employee benefits. The index is computed from data on compensation by occupation collected from a sample of more than 23,000 occupations within 4,400 establishments in the private sector. It is the only measure of labor that treats wages and salaries and total compensation consistently, and provides consistent subseries by occupation and industry. The ECI calculation for the rates of change for executive, administrative and managerial occupations in the private sector includes the salaries and wages of executives employed in the insurance industry.

The unreasonableness of the increases is further highlighted when the compensation packages for BCBSM executives are compared to executives at other Blue Cross plans. According to the National Blue Cross and Blue Shield Association (BCBSA), the average CEO salary of 72 plans nationwide was \$388,164 in 1991. In contrast, the BCBSM CEO's salary was \$777,225 in 1991, over 100 percent greater than the national average. In addition, a 1991 BCBSA survey of 68 plans determined that the average plan subscriber membership size was 1.2 million, (BCBSM reported 1.4 million subscribers) with 26 plans reporting more than a million subscribers. Of the 26 plans with over a million subscribers, the average total cash compensation for CEOs was \$458,000, approximately 70 percent or \$319,000 less than the compensation paid to BCBSM's CEO in 1991.

The BCBSM also stated that the increases in executive compensation were supported by a 1990 study prepared by a national consulting firm, TPF&C. In its study, TPF&C used a group of 1,700 companies, 25 percent from general industry, 25 percent from the insurance industry, and 50 percent from financial related industries. As part of their testimony, the Subcommittee's investigative staff analyzed the TPF&C's compensation study and raised several concerns about its validity.

"The Staff has several problems with this comparative group of 1,700 companies used by Towers Perrin to determine that Blue Cross salaries were "competitive." First and foremost, the Staff was unable to obtain the list of 1,700 companies and the compensation packages of its top executives. Towers Perrin did not maintain such a list, but instead, indicated to the Staff that much of their study was based on information collected in other studies. The Staff questions the validity of such an analysis which involves so many unknown companies.

Secondly, the vast majority of the companies used in the Towers Perrin study consisted of for-profit companies. The Staff feels that a more accurate comparison would include only non-profit organizations and especially other Blue Cross and Blue Shield plans.

Another problem arises from the fact that the study analyzed the compensation packages of the top 26 executives at Blue Cross and Blue Shield of Maryland. The Staff wonders how Towers Perrin was able to compare the salary of the Director of

the Medicare division of Blue Cross with that of an executive from General Motors or Merrill Lynch."

The BCBSM stated that our analysis incorrectly included non-compensation payments to executives as part of their total compensation packages; and failed to utilize a constant set of positions and individuals throughout the analysis. In performing our analysis of executive compensation increases, we relied on wage and employment information supplied to us by BCBSM. The original compensation information provided by BCBSM was apparently inadequate since it did not separately identify relocation expenses, payments for prior years service, and life insurance premiums. As a result, the above items were included by the OIG in the analysis as part of the executives' total compensation. Based on the supplemental information provided by BCBSM, changes have been made in the calculation of the excess executive compensation increases and incorporated into this report.

Our analysis compared executive compensation increases over time, because we believe that such increases are as much a function of time employed as to market employment dynamics. Due to the turnover of executives at BCBSM, we found it impossible to analyze the compensation packages of the 11 executives over the entire audit period. As a result, we compared compensation increases for executives that were employed at least two full years during the audit period.

Performance and Incentive Bonuses

During the review period, the BCBSM allocated a total of \$372,924 in performance and incentive bonuses to the Medicare Part A program.

Of the \$372,924, we believe that \$295,041 in performance and incentive payments included in the BCBSM's compensation packages represents excessive and unreasonable charges to Medicare Part A.

BCBSM paid over \$15.4 million to employees in incentives and bonuses from 1989 through 1992. Medicare Part A was allocated \$372,924.

From 1989 to 1992, BCBSM paid over \$15.4 million in performance and incentive bonus payments to its employees, including \$1.19 million awarded to Medicare employees and about \$4.4 million awarded to employees in corporate cost centers allocating to Medicare lines of business.

In accordance with the FAR, 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.

As part of their employee's compensation package, we believe BCBSM included \$295,041 in performance and incentive bonuses that represents excessive and unreasonable allocations to the Medicare Part A program as shown below.

- The BCBSM allocated (from corporate cost centers)¹ \$61,484 in performance and incentive bonuses that were awarded to corporate employees based on the performance of BCBSM's subsidiaries or their private lines of business. We are questioning the entire amount.
- The BCBSM allocated to Medicare employees \$311,440 in performance and incentive bonuses. We are questioning a total of \$233,557 as excessive, unreasonable, or unrelated to Medicare.

Corporate Incentives

The BCBSM allocated \$61,484 in performance and incentive bonuses that were awarded to corporate employees based on the performance of BCBSM's subsidiaries or their private lines of business.

Section 31.202 (a) of the FAR states:

"A direct cost is any cost that can be identified with a final cost objective...Costs identified specifically with the contract are direct costs of the contract and are to be charged directly to the contract. All costs specifically identified with other final cost objectives of the contract are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly."

Our review found that BCBSM allocated to Medicare performance and incentive bonuses paid to corporate employees based on financial performance results of non-Medicare business units. These costs were clearly identifiable with the performance of BCBSM's subsidiaries or their private lines of business and therefore, not eligible for allocation to the Medicare contract.

Performance and incentive bonuses, while available to most BCBSM employees in some form, are primarily structured to reward already highly compensated executives and professionals. Among the bonuses paid to executives at the director and senior positions is a sign-on bonus, comparable to bonuses received by professional athletes when negotiating contracts. Following is an excerpt from an employment confirmation letter sent by BCBSM to a new executive.

"I am delighted to offer you the position of Chief Financial Officer....Specific details of this offer are as follows: A beginning base salary of \$140,000 annually. A sign-on bonus of \$10,000 payable now. An additional bonus of \$10,000 attributable to 1989, payable at your discretion. We are currently finalizing a highly leveraged incentive compensation plan. However, as part

¹ Does not include incentives and bonuses of executives whose total compensation packages were reviewed as part of excessive executive compensation.

of our employment arrangement, your minimum potential incentive will be \$35,000 in 1990."

In addition to the signing bonus, BCBSM executive employees also receive annual performance and incentive bonuses. The incentive plan, according to BCBSM, is intended to:

"... promote the achievement of important business objectives and interests of Blue Cross/Blue Shield of Maryland (BCBSMD) by potentially providing annual financial rewards to key executives and managers of BCBSMD based on performance."

We believe that the \$61,484 in performance and incentive bonuses allocated to the program are directly related to corporate cost centers, and as such, are not allocable to the Medicare contract.

Medicare Incentives

From 1989 through 1992, the BCBSM awarded \$1,191,808 in performance and incentive bonuses to Medicare employees, \$311,440 of which was allocated to the Part A program. Of the \$311,440, we are questioning a total of \$233,557 that, we believe, represents excessive and unallowable charges to Medicare for the following two reasons:

- ✓ \$42,916 for performance and incentive bonuses that were funded based solely on the profitability of BCBSM non-Medicare lines of business.
- ✓ \$190,641 for performance and incentive bonuses awarded to Medicare supervisors and management level employees that were excessive and unreasonable charges in relation to benefits received by Medicare from such payments and the program's status within BCBSM.

Under the FAR, performance incentive payments are generally an allowable cost. However, for any cost to be assignable to the Medicare contract, the costs must also meet additional standards, primarily whether they are allocable, reasonable, and necessary to the overall operation of BCBSM and the Medicare Part A program.

Non-Medicare Related Incentives

Corporate guidelines, circa 1990, based incentive funding for eligible employees on the achievement of either corporate wide or business unit goals in addition to individual performance. Actual performance and incentive payouts, however, depended on whether the corporation as a whole was profitable. Revised guidelines in 1991 tied all incentive funding with corporate profitability. Incentive funding for

BCBSM guidelines tie all incentive awards to corporate profitability.

BCBSM business units is based on a ratio of 25 percent corporate performance and 75 percent business unit performance. For all other divisions of BCBSM, funding is based 100 percent on corporate results.

As noted, BCBSM incentive funding for CYs 1991 and 1992 was based solely on corporate financial results or a combination of corporate and business unit results for distinct divisions, such as Medicare. The result of BCBSM's policy to tie-in corporate and Medicare performance created a Medicare incentive funding pool which included a significant portion (25 percent) of the funding based on corporate financial performance. As a result, of the \$171,665 in incentive bonuses allocated to the Part A program during FYs 1991 and 1992, \$42,916 was awarded to Medicare employees based not on the performance of the Part A program, but on the overall profitability of BCBSM's subsidiaries and private lines of business. We believe that these costs are non-Medicare related and, as such, are not eligible for allocation to the Medicare contract.

Unreasonable Medicare Related Incentives

Of the \$1,191,808 in performance incentives and bonuses awarded to Medicare employees during our review period, \$665,372 (\$225,070 allocated to Part A) was awarded to supervisors and management level Medicare employees. Based on the results of our review, we are questioning \$190,641² in bonuses awarded to the above classes of Medicare employees because, we believe, that the costs are excessive and unreasonable charges to the program in comparison to the relative benefits received by Medicare.

From CYs 1989 through 1992, Medicare supervisors and management level employees, while comprising 11.8 percent of the total number of Medicare employees receiving performance bonuses, accounted for 55.5 percent of the total bonuses awarded. Annually, they averaged bonuses of \$6,104. In contrast, non-management Medicare employees averaged \$648 per year in bonuses. Performance and incentive bonuses awarded to Medicare employees and executives were generally less than the bonuses awarded to their corporate counterparts.

Performance and incentive bonuses awarded to Medicare management level employees were as follows:

- \$51,000 to the Vice President of Medicare in 1991; \$26,500 in 1992. Incentive payments of \$32,200 for 1989 and \$27,100 for 1990 were paid from corporate cost centers that did not allocate to Medicare.

² \$34,429 of the \$225,070 in incentives was questioned as part of the \$42,916 in incentives unrelated to Medicare.

- Medicare Directors averaged \$13,400 in incentives in 1990; \$16,946 in 1991; and \$10,707 in 1992. Incentives averaged approximately 20 percent of their annual salaries from 1989 to 1991.
- Medicare Managers were awarded, on the average, \$4,588 in incentives in 1989; \$3,264 in 1990; \$3,679 in 1991; and \$3,823 in 1992.
- \$17,500 and \$52,900 awarded to a non-Medicare executive in 1989 and 1990. A Human Resource executive received \$9,348 in 1992.

However, the awards to Medicare employees, specifically Medicare executives, are truly significant considering that the Part A program averaged a \$627,000 deficit annually to BCBSM, exceeding \$2.5 million over the period of our review. As a result, we found it difficult to correlate the payment of bonuses to employees of an operating division that was a significant drain on the resources of the company.

By regulation, Medicare requires its contractors to administer the program in the most efficient and economical manner possible. Among the recurring deficiencies cited by HCFA during their annual evaluations (CPEP - Contractor Performance Evaluation Program) of BCBSM's operations was their high administrative costs. Although not formally an evaluation standard until 1992, HCFA repeatedly recommended that BCBSM significantly reduce their administrative costs while improving operational efficiency.

The HCFA's 1991 Annual Contractor Evaluation Report (the reporting mechanism for CPEP) focused specifically on BCBSM's high costs.

"In FY 1991, BCBSMD reported a total unit cost of \$4.75 which is slightly below the national average of \$4.80. However, BCBSMD enjoys the advantages of a less complex bill mix than many intermediaries and receives a large percentage of claims electronically. We believe that these factors should result in a total unit cost substantially below the national average. In view of the continued pressure on the federal budget, BCBSMD must increase its efforts to significantly reduce costs and improve operational efficiency."

The HCFA's concern over high cost and operational efficiency resulted in new CPEP standards in FY 1992. One of the new standards directly rated an intermediary's ability to implement measures which result in cost efficiencies in comparison to the level of work. The BCBSM did not earn any points in this standard and, as a result, was one of three contractors nationwide to fail the 1992 CPEP.

Consequently, we are questioning \$233,557 in performance and incentive payments included in BCBSM's employee's compensation package which, we believe, represents excessive and unreasonable charges to Medicare Part A.

BCBSM Comments

In its response to our draft report, BCBSM did not agree with our conclusion that the \$295,041 in performance and incentive awards represented excessive and unreasonable charges to the Medicare program. The BCBSM stated that our analysis did not conform with the requirements of §31.205-6(b) because it did not consider the reasonableness of the compensation packages of the employees as a whole by comparing the compensation to that of similar employees in similar companies of comparable size. The BCBSM believes that, when the compensation packages of these employees are considered as a whole, the packages are reasonable and fully consistent with compensation typically paid in the marketplace. The BCBSM stated that in setting salary levels it relied on national and regional surveys conducted by national firms.

In addition, BCBSM asserted that:

- (1) the \$61,484 in bonuses for non Medicare employees were assignable to Medicare. The BCBSM states that a percentage of the total compensation package of certain BCBSM employees was allocated to the Medicare program because these employees spent approximately this percentage of their time devoted to Medicare Part A activities; and that the incentives or performance component of the employee's total compensation was not a profit-sharing program in which the employees received a percentage of the profits of BCBSM or the business unit to which the employees were assigned.
- (2) the \$233,557 in bonuses for Medicare supervisory and management level employees were allowable costs. The BCBSM stated that the total compensation of certain employees in the Medicare division included incentive and performance compensation based on the financial performance of BCBSM as a corporate entity, and that the financial performance of BCBSM was used as one of the benchmarks to determine the employees' performance. The incentive compensation, however, constituted only one component of the employee's total compensation package.

OAS Response

We agree with BCBSM that a portion of the non-Medicare employees time was expended on Medicare related business. However, the performance and incentive bonuses awarded to these employees were based on the performance of BCBSM's subsidiaries and private lines of business--not their Medicare duties. Therefore, these bonuses should be treated as a direct cost and should be charged directly to the applicable cost center(s). These bonuses were paid to corporate employees based on the financial performance of non-Medicare business units, as a result, Medicare received no relative benefit.

We do not agree with BCBSM that bonuses awarded to supervisors and management level Medicare employees are allowable and allocable charges to the Medicare Program. We believe that the bonuses were excessive and unreasonable charges to the program in comparison to the relative benefits received by Medicare.

In determining reasonableness of compensation for personal services the FAR §31.205-6(b) states,

"Compensation will be considered reasonable if each of the allowable elements making up the compensation package is reasonable. ...the contracting officers or their representatives may challenge individuals elements of the compensation paid...."

Our review supported the fact that one portion (bonuses) of the compensation package, was not reasonable. According to BCBSM, bonus and incentive programs are established to provide a financial incentive to those whose performance exceeds the standards and add value to the organization as goals are met. Contrary to BCBSM's principles, bonuses and incentives were awarded employees for less than satisfactory performance and conditions as noted below.

- Deficit Spending - In our opinion, BCBSM did not administer the Medicare program in the most efficient and economical manner possible. As stated, over the period of our review, the program averaged a \$627,000 deficit annually.

Although the Medicare program does not participate in a profit-sharing program, according to the guidelines of BCBSM's profit-sharing program, the Plan itself makes adjustments when goals have not been met. Under its profit-sharing program, the Plan specifies that a rating below a specified amount would not generate profits sufficient to support profit-sharing. According to BCBSM's Supervisory Incentive Program guidelines, "both quality and productivity measures must be met in order to receive incentive". In our opinion, a program that consistently operates in deficit spending does not meet quality and productivity measures.

- High Costs - To further illustrate, the Subcommittee investigative staff included in their report the following memorandum on the administrative costs of the Plan as presented by a consulting firm:

"Booz and Allen concluded that administrative costs in the Plan are too high across the board. ...Because administrative costs have not been held in check, and the decentralization of the organization has been extensive, Booz Allen found that productivity in the Plan has actually declined over the last four to five years."

Further, in reference to the insurance industry 3-year down-cycle, the Subcommittee reported this excerpt from a presentation made to management by a BCBSM executive:

*"Mr. **** acknowledged immediately that the Plan was on very thin ice for entering the next down cycle. . . . He commented that one of the unusual characteristics of the last down cycle was that the Plan's administrative expenses were "way up while everything else went to hell."*

Lease Payments to Subsidiaries

From December 1987 through September 1988, BCBSM entered into sale and lease-back arrangements with a subsidiary corporation, Healthline, Inc. Under the agreements, BCBSM sold Healthline office furniture, cafeteria equipment, communication equipment, automobiles, and computer software. In January 1989, BCBSM discontinued the arrangements with Healthline, instead entering into new agreements with another subsidiary corporation, PERTEK. The lease arrangements resulted in Medicare being allocated \$422,584 more than would have been allocated had BCBSM not entered into these agreements. The FAR, §205-6(b)(2) states that:

"rental costs under a sale and leaseback arrangement are allowable only up to the amount the contractor would be allowed if the contractor retained title."

This means that Medicare could be charged no more costs after the sale and lease-back of the equipment than was charged prior to the sale and lease-back.

From 1989 to 1992, BCBSM paid \$6,230,406 to Healthline and PERTEK under the sale and lease-back agreements, \$497,057 of which was allocated to the Medicare Part A lines of business. Our review of Healthline corporate accounts found that only \$74,473 in depreciation expense was attributable to the Medicare leased assets, resulting in a difference of \$422,584 between the lease payments allocated to Medicare and the corporate records, as shown below:

DEPRECIATION AND LEASE PAYMENTS			
<u>Fiscal Year</u>	<u>Depreciation Accounts</u>	<u>Lease Payments</u>	<u>Difference</u>
1989	\$ 1,059	\$190,687	\$189,628
1990	10,014	125,553	115,539
1991	28,187	78,242	50,055
1992	<u>35,213</u>	<u>102,575</u>	<u>67,362</u>
Total	<u>\$74,473</u>	<u>\$497,057</u>	<u>\$422,584</u>

We discussed the above difference with BCBSM officials. The BCBSM officials could neither explain nor reconcile the difference between the depreciation and lease payment accounts. As a result, over the audit period, the excess allocation amounted to \$422,584, which, we believe, represents unallowable lease charges to Medicare.

BCBSM Comments

In its comments BCBSM disagreed that the sale and lease-back arrangements resulted in the Medicare program being allocated \$422,584 more than would have been allocated had BCBSM not entered into them. Its response stated that the OIG examined personal property that was not subject to the sale and lease-back arrangements and that these accounts were necessarily mutually exclusive.

OAS Response

We disagree with BCBSM's assertion that we examined accounts that were not associated with the sale and leaseback arrangements with Healthline and Pertek. Our review of the accounts was coordinated with BCBSM corporate accounting over a 4-month period. Each of the corporate/subsidiary depreciation accounts examined were reviewed and verified by BCBSM to be the correct account for our analysis. At no time during our review did BCBSM indicate that we were examining depreciation accounts not associated with the lease arrangements. Moreover, this situation was previously reported for FYs 1987 and 1988³. The BCBSM concurred with our finding and recommendation related to this issue in that report.

³ CIN-A-03-90-00051 issued August 13, 1991

Private Business Expenses

The BCBSM allocated \$5,309 to Medicare for costs related to BCBSM's subsidiaries or their private lines of business. This allocation was based on consulting and travel expenditures totaling \$155,737 from BCBSM corporate cost centers. As previously stated, FAR §31.202(a) states that costs specifically identified with final cost objectives other than the contract are direct costs of those objectives and not chargeable to the contract directly or indirectly.

Our review found that BCBSM allocated to Medicare consulting charges and associated travel expenses for a detailed consumer field study concerning various BCBSM product lines. These costs were identifiable with BCBSM's non-Medicare lines of business and, therefore, were not eligible for allocation to the Medicare program.

BCBSM Comments

In its response to our draft report, BCBSM agreed that private business costs were improperly allocated to the Medicare program.

Charitable Contributions

The BCBSM allocated \$1,828 to Medicare based on \$60,974 in unallowable charitable contributions made in FYs 1989 and 1990. FAR §31.205-8 states that contributions or donations, including cash, property and services, regardless of recipient, are unallowable, except as provided in §31.205-1(e)(3). This section allows the costs of participation in community service activities, such as blood drives, charity drives, savings bond drives and so on. It does not allow charitable donations. The funds were donated to such charities as the United Way and were unallowable charges to Medicare.

BCBSM Comments

In its response to our draft report, BCBSM agreed that the costs of charitable contributions were improperly allocated to the Medicare program.

Other Expenditures

The BCBSM allocated \$7,973 to Medicare for miscellaneous unallowable costs totaling \$173,895. These costs include:

- \$78,797 (\$5,213 allocated to Medicare) for staff meetings.

- \$7,421 (\$365 allocated to Medicare) for entertainment expenses including dues to private social clubs and tickets to sporting events.
- \$5,079 (\$133 allocated to Medicare) in costs associated with chartered air-service for the President of BCBSM.
- \$4,416 (\$410 allocated to Medicare) in gifts, including the purchase of Monet coffee table books for the Board of Directors.
- \$3,838 (\$88 allocated to Medicare) in limousine services for the President, senior executives and members of the Board of Directors.
- \$74,344 (\$1,764 allocated to Medicare) for other miscellaneous unallowable costs.

BCBSM Comments

In its response to our draft report, BCBSM agreed that these unallowable costs were allocated to the Medicare program.

UNSUPPORTED COSTS ALLOCATED TO MEDICARE

The BCBSM needs to adhere to its documented procedures and Medicare guidelines to ensure that proper and adequate documentation is maintained in support of charges made to the Medicare program. Documentation maintained by BCBSM for contractual services failed to include data that is necessary to determine whether the charges for services are appropriate. As a result, BCBSM allocated \$34,973 to Medicare Part A for \$643,867 in costs for which the documentation supporting the expenditure was not adequate to determine the nature, type, reasonableness or necessity of the expense. Section 1504 of the HCFA Intermediary Manual states that:

"The intermediary shall maintain books, records, documents and other evidence pertaining to the costs and expenses of the agreement....These records shall be maintained to the extent and in such detail as will properly reflect all net costs, direct and indirect...of whatever nature claimed to have been incurred, and for which reimbursement is claimed under the provisions of the agreement."

During our transactional analysis, we identified transactions totaling \$643,867 for which BCBSM did not provide supporting documentation or the documentation provided proved inadequate. As a result, we were unable to verify the accuracy of the transaction or determine the relationship of the expense to the Medicare program.

The majority of the inadequately supported costs resulted from contractual agreements. The BCBSM was asked to provide documentation that would show that the charges for services are appropriate considering the qualifications of the consultants, their normal charges, and the nature of the services rendered which would enable us to determine whether or not the costs were allowable and allocable to Medicare. This documentation has not been provided.

Therefore, unless BCBSM can provide sufficient documentation to make a determination on the allowability of these costs, the \$34,973 allocated to Medicare should be excluded from the costs used to calculate the FACPs.

BCBSM Comments

In its response to our draft report, the BCBSM agreed to provide sufficient documentation for costs that we found to be unsupported. Failing to provide such sufficient documentation, the BCBSM agreed to exclude the unsupported costs from costs used to calculate the FACPs.

OAS Response

To date, BCBSM has not submitted any additional documentation for our review. Therefore, unless BCBSM can provide adequate documentation to HCFA, these costs should be disallowed.

CONCLUSIONS AND RECOMMENDATIONS

Our review of booked costs for FYs 1989 through 1992 showed that BCBSM did not adequately screen unallowable costs from being allocated to the Medicare program. As a result, BCBSM allocated unallowable and unsupported costs of \$898,627 to the program.

We, therefore, recommend that BCBSM:

1. Strengthen its cost allocation system to assure that unallowable costs, including the type identified in this report, are not allocated to the Medicare program in the future.
2. Coordinate with HCFA to reduce the costs claimed on FYs 1989 through 1992 FACPs by \$863,654.
3. Provide adequate documentation for unsupported costs of \$34,973 or make the appropriate adjustment to the FACPs.

Medicare



**BlueCross BlueShield
of Maryland**

An Independent Licensee of the
Blue Cross and Blue Shield Association

1946 Greenspring Drive
Timonium, Maryland 21093-4141

February 17, 1995

Mr. Thomas J. Robertson
Regional Inspector General for Audit Services
Department of Health and Human Resources
Region III
3535 Market Street
Philadelphia, Pennsylvania 19104

Dear Mr. Robertson:

Enclosed are responses to Blue Cross and Blue Shield of Maryland's Draft Reports entitled "Review of **Medicare Part A** Administrative Costs for Fiscal Years 1989 - 1992" (CIN: A-03-93-00020), and "Review of **Medicare Part B** Administrative Costs for Fiscal Years 1989 - 1992" (CIN: A-03-93-00021).

These responses are being submitted concurrently based on prior discussions and extensions granted for February 19, 1995. We appreciate your patience and understanding during this time when most of our financial and operations staff was committed to Medicare B transition activities.

If you have any questions, please call me at (410) 998-5370, or Brian Austin of my staff at (410) 561-4270.

Sincerely,

A handwritten signature in black ink, appearing to read "Don Beauchesne".

Don Beauchesne
Senior Vice President,
Operations

**BLUE CROSS AND BLUE SHIELD OF MARYLAND, INC.
REVIEW OF MEDICARE PART A ADMINISTRATIVE
COSTS FOR FISCAL YEARS 1989 THROUGH 1992**

THE INTERMEDIARY RESPONSE TO THE DRAFT AUDIT REPORT

CIN: A-03-93-00020

February 19, 1995

GENERAL COMMENTS

On December 19, 1994, the Office of Inspector General of the U.S. Department of Health and Human Services ("OIG") issued a draft report entitled "Review of Medicare Part A Administrative Costs for Fiscal Years 1989-1992" in which the OIG addressed the validity of administrative costs claimed by Blue Cross and Blue Shield of Maryland ("BCBSM") for this period. During the audit period, BCBSM claimed a total of \$26,019,364 in administrative costs relating to its provision of services as an Intermediary responsible for administering Part A (Hospital) claims submitted to the Medicare program by providers of services in Maryland. In the draft report, the OIG stated that BCBSM improperly allocated costs totaling \$930,756 to the Medicare program which were unallowable in accordance with applicable Federal regulations and the terms of BCBSM's Medicare contract. These costs consisted of \$895,783 of unallowable costs and \$34,973 of unsupported costs. The categories of unallowable costs included (1) \$439,939 of unallowable compensation, (2) \$422,584 of lease payments, (3) \$18,150 of productivity investment projects, (4) \$5,309 of private business expenses, (5) \$1,828 of charitable contributions, and (6) \$7,973 of other miscellaneous expenditures. The OIG asked BCBSM to respond to the draft report by February 19, 1995. For the reasons stated below, the company disagrees with the conclusions of the draft report.

BCBSM believes that the costs claimed on its Final Administrative Cost Proposals ("FACPs") were for the benefit of the Medicare Part A program, were equitably and consistently allocated, were reasonable in amount and were allowable under BCBSM's October 1, 1987 contract with the Department of Health and Human Services, Health Care Financing Administration (the "Contract"). This response will address in turn the categories of unallowable costs described in the OIG's draft report.

COMPENSATION

In the draft report, the OIG asserted that BCBSM allocated to the Medicare Part A program \$439,939 in what the OIG found to be unallowable compensation. The OIG pointed to two categories of unallowable compensation: (1) \$144,898 in allegedly unreasonable executive compensation increases, and (2) \$295,041 in performance and incentive compensation that was paid to both employees who were in business divisions other than the Medicare division and Medicare division employees.

BCBSM respectfully submits that the OIG's methodology for determining the reasonableness of compensation of both executives and employees was inconsistent with the applicable Federal Acquisition Regulations ("FAR"), 48 CFR §31.205-6(b).

Section 31.205-6(b) states that the compensation for personal services paid or accrued to each employee must be reasonable for the work performed. Under this regulation, compensation will be considered reasonable if each of the allowable elements making up the employee's compensation is reasonable. Further, in determining the reasonableness of individual elements for employees, or classes of employees, consideration must be given to all potentially relevant facts, including (1) general conformity with the compensation practices of other firms of the same size, (2) the compensation practices of the other firms in the same industry, (3) the compensation practices of other firms in the same geographic area, (4) the compensation practices of firms engaged in predominantly non-Government work, and (5) the cost of comparable services obtainable from outside sources.

Section 31.205-6(b) further provides that, while all of the above factors should be considered, their relative significance must vary according to circumstances. The section states that "[f]or example, in the case of secretarial salaries conformity with the compensation paid by other firms in the same geographic area would likely be a more significant criterion than conformity with the compensation paid by other firms in the same industry wherever located."

Additionally, §31.205-6(b) requires that, in determining the reasonableness of compensation, the entire circumstances of the employee's compensation package should be considered as a whole. For example, a contractor, if challenged on the amount of base salaries for management employees, may counter by showing lower than normal end-of-year management bonuses and vice-versa. Stated another way, the employee's compensation package must be considered as a whole to determine if it is reasonable. Section 31.205-6(b) expressly recognizes that the compensation package of an employee or class of employees may include any of the following elements: (1) wages and salaries, (2) incentive compensation, (3) deferred

compensation, (4) pension and savings plan benefits, (5) health insurance benefits, (6) life insurance benefits, and (7) compensated personal absence benefits.

In the case of senior executives, the compensation package was reviewed in a February 19, 1990 study by a national firm of recognized expertise in the field of executive compensation, TPF&C. It is entirely reasonable that BCBSM would rely, in establishing executive compensation, upon the opinion of a nationally recognized firm such as TPF&C. In the case of other employees, the compensation package was established by the company's Human Resources Department after researching levels of compensation for comparable positions through, among other things, the best available published information.

1.

In the draft report, the OIG did not analyze the reasonableness of compensation paid to BCBSM executives during the audit years by comparing their compensation to that of similar executives in similar companies of comparable size as required by §31.205-6(b). Instead, the OIG looked only at increases in executive compensation from the base year, 1988. The OIG did not attempt to determine the reasonableness of the base year used in their comparison of compensation packages.

The draft report states that, during the four year period under audit the average annual compensation package of 12 of the highest paid executives at BCBSM rose from an average of \$145,430 in 1988 to \$301,944 in 1992, an increase of 107.7%. The OIG states that this increase was 93% higher than the national average as calculated by the U.S. Department of Labor Bureau of Labor Statistics Employment Cost Index ("ECI"), which rose a combined 14.6% for executive and managerial employees during the audit period. According to the OIG, the executive compensation increases exceeded the ECI by \$3,372,460. Of this amount, \$144,898 was allocated to the Medicare Part A program.

The OIG's analysis is incorrect and not in accordance with the governing regulation because it (a) did not use an adequate source of outside data to consider the reasonableness of the compensation of the 12 executives in each year of the audit period, (b) incorrectly included non-compensation payments to executives as part of the determination of the total compensation paid to the executives, and (c) failed to recognize that individuals included in the analysis worked partial years, and failed to utilize a consistent set of positions and individuals throughout the analysis, resulting in a distortion of the total increase in compensation figure attributable to the BCBSM executives.

(a)

The OIG's analysis was inconsistent with § 31.205-06(b) because it merely compared increases in total compensation to increases in the ECI and did not determine the reasonableness of executive compensation for each year under audit. BCBSM believes that the use of ECI by the OIG is inconsistent with § 31.205-6(b) because it does not even purport to determine the reasonableness of compensation levels during the audit years. Further, the OIG's analysis violates § 31.205-6(b) because:

1. The statistics included in the ECI do not consider data from "other firms of similar size" as required by § 31.205-6 (b), but rather are based on 4,400 private non-farm establishments. This deviation from the requirement of the regulation is particularly inappropriate here because of the size of BCBSM -- one of the largest employers in Maryland.
2. The statistics included in the ECI do not consider data from "other firms in the same industry" as required by § 31.205-6 (b). Rather, the ECI utilizes fixed weights to "ensure that changes in these indexes reflect only changes in compensation, not employment shifts among industries or occupations ..." A substantial shift in labor supply and demand occurred in the health care and health care insurance related markets during the late 1980s and early 1990s. Thus, any analysis of BCBSM's executive compensation -- unlike the OIG's ECI analysis -- must consider the insurance industry dynamics as required by § 31.205-6 (b).

The compensation at BCBSM for executives should be compared with the compensation practices of comparable firms engaged in predominantly non-Government work in the insurance industry, and the cost of comparable services obtainable from outside sources.

Executive compensation at BCBSM was supported by a February 19, 1990 study prepared by TPF&C. The purposes of the TPF&C study were to: (1) develop base salary, annual incentive and total cash compensation market rates for senior executive positions at BCBSM, (2) assess the competitiveness of BCBSM's cash compensation program and annual and long term incentive plans in light of external marketplace data, (3) develop suggested 1990 salary ranges for these positions, and (4) develop competitive marketplace data on executive benefits programs. In preparing the study, TPF&C matched BCBSM's positions with positions in general industry, financial services and insurance companies on the basis of: (1) similar job duties, responsibilities and work requirements, and (2) organizations similar in size to BCBSM (approximately \$1 billion to \$2 billion in revenues). TPF&C obtained data from three relevant industry data bases: general industry (weighted 25%), financial services (weighted 50%), and

insurance companies (weighted 25%). TPF&C developed median and 75th percentile cash compensation rates for the surveyed positions.

Because TPF&C's study showed that the total compensation of BCBSM executives was less than competitive, TPF&C recommended that the compensation packages be adjusted to provide additional compensation-related elements to reach a competitive position and thereby ensure the continued retention of qualified individuals in these positions.

It is respectfully submitted that OIG has not provided any substantive basis for its assertion that executive compensation levels at BCBSM during the audit period were excessive.

(b)

Relocation payments are not included in the definition of remuneration for personal services set forth in the Federal Acquisition Regulations. Relocation expenses paid to executives are generally allowed as deductible expenses for relocating new employees. Six individuals who were included in the OIG work-papers (WPP3, WPP4, WPP6, WPP7, WPP8, and WPP10) had transfer expenses paid during the period 1988 through 1992. Amounts for relocation and transfer-cost reimbursement were erroneously included in the OIG report as "compensation for personal services" as detailed below:

<u>Individual</u> ¹	<u>Year</u>	<u>OIG</u> ² <u>Used</u>	<u>W2plus</u> <u>Deferred</u>	<u>Transfer in</u> <u>Relocation Exp.</u>	<u>Should use</u> <u>Adjusted</u> ³
WPP3	88	180,471	201,989	12,784	189,205
WPP4	88	127,500	37,538		37,538
	88	188,490	183,490	45,032	143,458
	90	241,035	243,189	2,155	241,034
	91		209,367		209,367
WPP6	88	196,828	195,783	4,227	191,556
	92	330,385	320,785		320,785
WPP7	89	133,006	137,619	47,952	89,667
	90	211,332	211,332	56,962 ⁴	151,370

¹ Individuals are identified as Work Paper Person (WPP) and a number in order down the column of the OIG work-paper spreadsheet titled BCBSM Executive Salary Analysis Calendar Years 1989 to 1992.

² Taken from OIG work-paper spreadsheet titled BCBSM Executive Salary Analysis Calendar Years 1989 to 1992.

³ These numbers used as compensation for the remainder of this report.

WPP8	89	120,150	127,777 ⁵	31,864	95,913
	90	178,391	177,092 ⁶	2,225	174,867
	91	275,090	273,010 ⁷	34,131	238,879
	92	260,676	259,120 ⁸	2,231	256,889
WPP10	90	118,558	127,519	3,709	123,810

Accordingly, the OIG's incorrect inclusion of relocation payments in total compensation paid BCBSM executives resulted in the significant overstating of that compensation.

(c)

The OIG failed to recognize that certain individuals included in its analysis worked partial years in the base year, or a later year, and failed to utilize a consistent set of individuals and positions throughout the analysis. These errors led to a significant distortion of the total figure derived for compensation increase. For example, the salaries of WPP7 and WPP11 are included for later years in the work-paper analysis but are shown as zero in the base year. A new person not included in the OIG work-papers (designated as NWPP1) served in a related VP position in 1988 but was not included in the base year of the analysis. Similarly, another person (NWPP2 designation) served in 1988 and 1989 as a vice president in a position for which the OIG workpapers included only individuals WPP4 and WPP10 in later periods. Furthermore, both individuals (WPP4 and WPP10) were included in the OIG analysis without regard to timing of movement in and out of the position that they occupied. Thus, the OIG workpapers erroneously included them both for the full year of 1991.

The exclusion of the two individuals designated NWPP and the failure to recognize partial years versus full years in certain positions significantly distorted the results presented in the OIG draft report. Compensation paid to individuals serving in two of the VP positions (designated B and C below) (containing executives WPP4 and WPP7) were reasonable because 1) the compensation step-up/step-down year (1989) was the result of market wage pricing determined by the hiring of new individuals from two very large companies with market based expectations (WPP7 came from IBM and WPP4 came from Electronic Data Services), and 2) the

(Footnote continued from previous page)

⁴ Severance payment.

⁵ OIG-HCFA failed to include 401k deferred compensation amount.

⁶ OIG-HCFA apparently included imputed cost of life ins. -- also counted in "Wages, tips, other compensation".

⁷ OIG-HCFA apparently included imputed cost of life ins. -- also counted in "Wages, tips, other compensation".

⁸ OIG-HCFA apparently included imputed cost of life ins. -- also counted in "Wages, tips, other compensation".

overall annual rates of compensation change do not appear to be nearly as high as double digit rates asserted in the OIG report. The average annual increases actually were 9.3% and 9.7%, respectively. Reviewing the increases for the other positions (A and D) we noted average annual increases of 8.5% and 12.7%, respectively. The actual rates of increase in compensation for these positions do not even approach the rates stated in the OIG draft report. The following chart depicts the correct percentage increase in compensation for the positions designated A through D:

POSITION A:

- WPP6	1988		\$ 191,556	
- WPP6	until 6/89 @42%	\$78,513		
- WPP8	arrived 6/89	<u>95,913</u>	174,426	- 8.9 %
- WPP8	1990		174,867	0.3 %
- WPP8	1991		238,879	36.6 %
- WPP8	1992		256,889	7.5 %

Overall the VP Position went from \$191,556 to \$ 256,889 or an **average 8.5% increase** per year for four years.

POSITION B:

- NWPP1	1988		\$ 114,051	
- NWPP1	until 5/89 46%	\$53,462		
- WPP7	start 5/89	<u>89,667</u>	143,129	25.5 %
- WPP7	until 9/90 @ 75%	151,370		
- WPP11	from 9/90 @ 25%	<u>21,900</u>	173,270	21.1 %
- WPP11	1991		130,423	-24.7%
- WPP11	1992		<u>158,414</u>	21.5%

Overall the VP Position went from \$114,051 to \$158,414 or an **average 9.7% increase** per year for four years.

POSITION C:

- NWPP2			\$ 137,836	
- NWPP2	until 3/89	\$37,757		
- WPP4	started 9/89	<u>135,000</u>	172,757	25.3 %
- WPP4	1989		143,458	-17.0 %
- WPP4	1990		241,034	68.0 %
- WPP10	1991		147,850	-38.7 %
- WPP10	1992		<u>189,034</u>	27.9 %

Overall the VP Position went from \$137,836 to \$189,034 or an **average 9.3% increase** per year for four years.

POSITION D:

- NWPP3	1988		\$ 97,027	
- NWPP3	1989		114,157	17.7
- NWPP3	until 4/90	33%	\$65,474	
- WPP12	from 4/90	67%	78,499	143,973
- WPP12	1991			26.1 %
- WPP12	1992		132,548	-7.9
			<u>146,220</u>	<u>10.3 %</u>

Overall the VP Position went from \$97,027 to \$146,220 or an **average 12.7% increase** per year for four years.

Accordingly, the OIG's analysis overstated the increases in BCBSM's executive compensation for the audit years.

2.

In the draft report, the OIG asserted that \$295,041 in performance and incentive compensation paid to BCBSM employees represented excessive and unreasonable charges to the Medicare Part A program. Specifically, the OIG asserted that these allegedly excessive and unreasonable allocations included: (1) \$61,484 in performance and incentive compensation paid to corporate employees and allocated to the Medicare program based on the financial performance of BCBSM as a corporate entity and the business unit to which the corporate employee was assigned, and (2) \$233,557 in performance and incentive compensation paid to Medicare employees. As will be explained in detail below, the OIG's analysis did not conform with the requirements of §31.205-6(b) because it did not consider the reasonableness of the compensation packages of the employees as a whole by comparing the compensation to that of similar employees in similar companies of comparable size. BCBSM believes that, when the compensation packages of these employees is considered as a whole, the packages are reasonable and fully consistent with compensation typically paid in the marketplace.

(a)

The OIG asserted that the \$61,484 in performance and incentive compensation paid to employees not assigned to the Medicare division based in part on the performance of BCBSM and the business unit to which the employees were assigned could not be allocated to the Medicare Part A program. The OIG reasoned that, under §31.202(a), these payments were not

direct costs of the Medicare contract because the incentive or performance payments were based on the financial performance of other divisions of BCBSM, not the Medicare division.

BCBSM respectfully submits that the conclusions of the OIG are incorrect. A percentage of the total compensation package of certain BCBSM employees was allocated to the Medicare Part A program because these employees spent approximately this percentage of their time devoted to Medicare Part A activities. For example, a percentage of the compensation of maintenance employees, Legal Department employees and Human Resources Department employees were allocated to the Medicare Part A program because these employees performed functions that were necessary to the administration of the Medicare Part A program or to the company's overall business operations. Under § 31.201-4 of the FARs, "[a] cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits ... or is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown." It is appropriate, therefore, that a percentage of the employees' overall compensation package be allocated to the Medicare Part A program. The incentive or performance component of the employees' total compensation was not a profit-sharing program in which the employees received a percentage of the profits of BCBSM or the business unit to which the employees were assigned. Rather, the incentive program was fashioned to reward employees for effective or superior performance. The financial performance of BCBSM, the financial performance of the employees' individual business unit and the individual employee's performance were benchmarks used to determine whether incentive or performance compensation would be paid, and if so, in what amount. The incentive or performance compensation was paid to encourage employees to engage in effective or superior performance. Such performance benefited all programs to which the employee's work related, not just the division to which the employee was technically assigned. Accordingly, it is appropriate to allocate to the Medicare Part A program the incentive component of the total compensation package of these non-Medicare division employees.

BCBSM believes that, in determining the reasonableness of the compensation of its employees, the compensation packages should be considered as a whole. The company respectfully submits that the levels of compensation paid its employees were reasonable. The compensation levels were developed by the company's Human Resources Department which conducted analyses in the marketplace to establish the levels of total compensation. For employees in jobs that were not supervisory or management positions, the analysis involved use of the annual survey published by the Chesapeake Human Resources Association which survey contained benchmarks for such positions. Further, for employees in supervisory or management positions for whom a regional or national selection search would be appropriate, the Human Resources Department relied on regional or national surveys published by reputable firms such as William M. Mercer, Hay Company and the Wyatt Company. Incentive and performance compensation was paid to employees to reward effective or superior performance as part of total

compensation. It is unfair to suggest that the incentive component of the employees' total compensation is not allocable to Medicare merely because the benchmarks utilized in determining the effectiveness of the employees' performance included the financial performance of BCBSM and the employees' business units. The incentive or performance compensation was not profit sharing, and, if an employee's performance was found to be effective or superior, that performance benefited both the employee's business division and the Medicare program which made use of a portion of the employee's time.

(b)
Medicare Employees

The OIG asserted that \$233,557 in performance and incentive compensation paid to Medicare division employees which was allocated to the Part A program was excessive and not properly allocable to Medicare because (1) \$42,916 in performance and incentive compensation was based on the financial performance of BCBSM as a corporate entity, and (2) \$190,641 in performance and incentive compensation was unreasonable in relation to the benefits received by Medicare because BCBSM was a high cost contractor. BCBSM respectfully submits that these arguments are incorrect.

The total compensation of certain employees in the Medicare division included incentive and performance compensation based on the financial performance of BCBSM as a corporate entity. The financial performance of BCBSM was used as one of the benchmarks to determine the employees' performance. The incentive compensation, however, constituted only one component of the employees' total compensation package. BCBSM respectfully submits that the reasonableness of the total compensation package should be judged by comparing the compensation of BCBSM employees to comparable positions in the marketplace. The total compensation packages of Medicare division employees were established by the Human Resources Department after examination of the most relevant market surveys prepared by recognized, competent firms. Accordingly, BCBSM believes that the compensation paid to these Medicare division employees was reasonable, and the amounts allocated to the Medicare Part A program were appropriate.

Additionally, BCBSM disagrees with the OIG's conclusion that it was excessive to award any incentive compensation to Medicare division employees. It is important to note that BCBSM was a relatively small intermediary located in the Baltimore/Washington corridor, a high cost area for labor and other administrative costs. As previously indicated, because the total compensation of Medicare division employees was reasonable and fully consistent with the compensation paid for similar positions in comparable companies, no portion of their compensation should be disallowed.

LEASE PAYMENTS

In the draft report, the OIG asserted that, from December, 1987 through September, 1988, BCBSM entered into sale and leaseback agreements with a subsidiary, Healthline, Inc. in which BCBSM sold and leased back office furniture, cafeteria equipment, communication equipment, automobiles, and computer software. In January 1989, BCBSM discontinued the arrangements with Healthline and entered into such arrangements with another subsidiary, PERTEK. The OIG draft report alleged that the sale and leaseback arrangements resulted in the Medicare Part A program being allocated \$422,584 more than would have been allocated had BCBSM not entered into them.

BCBSM respectfully submits that the OIG's analysis is incorrect. According to the OIG, only \$74,473 in depreciation expense would have been incurred by the Medicare Part A program if BCBSM had retained the personal property and not entered into the sale and leaseback arrangements. The OIG derived the \$74,473 depreciation figure by looking at a Medicare Part A depreciation account.

The depreciation account the OIG examined involved personal property not subject to the sale and leaseback arrangements. The accounts were necessarily mutually exclusive. Accordingly, the OIG's comparison of the accounts does not indicate that the sale and leaseback arrangement resulted in additional expense being allocated to the Medicare Part A program.

PRODUCTIVITY INVESTMENT PROJECTS

The draft audit report asserted that \$18,150 of BCBSM's total claim related to Productivity Investment Projects was unallowable because OIG found that amount to exceed the approved budget for Productivity Investment Projects.

The Medicare Part A contract and HCFA issued annual Budget and Performance Requirements (BPRs) allowing intermediaries to allocate 5 percent of budgeted funds between lines for the HCFA-1523 reporting process. BCBSM was within the 5 percent limitation cited below. Therefore, being over budget for Productivity Investment Projects is not a valid argument to disallow them. The following matters should be considered:

The Medicare A Contract, Article VI.D states:

The Plan 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 ...

Medicare Budget and Performance Requirements (BPRs), General Instructions (Parts A & B) for Fiscal Year 1992 state:

Productivity Investments and 'Other' line funding not governed by contract modification may be shifted to other functions not to exceed 5%.

Accordingly, the \$18,150 found unallowable by OIG should be allowable under the above provision of the contract.

**PRIVATE BUSINESS EXPENSES, CHARITABLE CONTRIBUTIONS,
AND OTHER EXPENDITURES**

In the draft report, OIG asserted that BCBSM allocated to the Medicare Part A program certain private business expenses, charitable contributions and other miscellaneous expenditures which OIG determined to be unallowable. These costs included:

- (a) \$5,309 for costs based on consulting and travel expenditures related to BCBSM's subsidiaries and private lines of business;
- (b) \$1,828 in charitable contributions
- (c) \$7,973 in miscellaneous costs

BCBSM will not contest the conclusions the OIG draft report as to the unallowability of these costs.

UNSUPPORTED COSTS

The draft report asserted that \$34,973, allocated by BCBSM to the Medicare Part A program was unallowable because OIG found insufficient documentation which would support the appropriateness of the charges for services.

BCBSM will provide to OIG sufficient documentation to make a determination as to the allowability of these costs or, if BCBSM is unable to provide sufficient documentation, it will exclude these costs from costs used to calculate the FACPs.