

**Memorandum**

Date NOV 21 2001
From Janet Rehnquist *Janet Rehnquist*
Inspector General
Subject Summary Results of Review of the Administrative Cost Component of the Adjusted
Community Rate Proposal at Ten Medicare+Choice Organizations for the 2000 Contract
Year (A-03-01-00017)
To
Thomas Scully
Administrator
Centers for Medicare & Medicaid Services

In an Office of Inspector General (OIG) audit report issued in January 2000, *Review of the Administrative Cost Component of the Adjusted Community Rate Proposal at Nine Medicare Managed Care Organizations for the 1997 Contract Year, A-03-98-00046*, we identified \$66.3 million of inappropriate administrative costs that were included in the adjusted community rates (ACR) submitted by nine managed care organizations (MCO). These costs would have been unallowable had the Centers for Medicare & Medicaid Services (CMS) required the MCOs to follow Medicare's general principle of paying only reasonable costs. The former CMS Administrator requested OIG to examine additional MCOs' administrative costs. However, she wanted the reviews performed at MCOs who submitted ACRs under the revised ACR format. This report summarizes our response to CMS's request and will, hopefully, be useful to you in working with the MCOs.

The objective of our reviews was to determine if the base year costs included in the administrative component of the Contract Year (CY) 2000 ACRs submitted by the MCOs were appropriate when compared to the Medicare program's general principle of paying only reasonable costs. This report includes audit results of 10 MCOs, one each located in Florida, Nevada, New Jersey, New York, Ohio, Pennsylvania, Texas, and Washington, and two located in Missouri. We previously submitted to CMS the individual reports related to these States.

The summary of our 10 MCOs' administrative cost audits showed that \$97.1 million of base year costs would have been recommended for disallowance had the MCOs been required to follow the Medicare program's general principle of paying only reasonable costs. As you know, since there is no statutory or regulatory authority governing allowability of costs in the ACR, the MCOs were not required to adhere to this principle. The \$97.1 million costs included:

- \$46.3 million in unresolved costs reported by seven MCOs resulting from \$45.0 million of related party transactions that were not based on incurred costs and \$1.3 million of insufficiently documented costs;

- \$45.3 million in questionable allocations reported by eight MCOs resulting from improper allocations of non-Medicare costs to the Medicare line of business and/or excessive cost allocations that would have been disallowed had CMS required MCOs to follow the Medicare cost contract criteria which required that indirect costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment; and
- \$5.5 million for costs unallowable under the Federal Acquisition Regulation part 31 Contract Cost Principles and Procedures which other Medicare organizations, not MCOs, are required to follow. The costs related to entertainment, gifts, and employee morale; lobbying and legal expenses; public relations; taxes; bad debts; contributions and sponsorships; and miscellaneous items. All 10 MCOs reported at least 1 of these cost elements.

Based on our audit results, we removed what would have been unallowable costs (as noted above) and recalculated the ACRs. Our adjustments reduced the CY 2000 estimated Medicare administrative costs at eight MCOs (we were unable to determine adjustments for two of the MCOs) by an average of \$32.74 per member per month (PMPM). In comparison, the estimated average cost of the additional benefits offered for CY 2000 by these MCOs equaled \$34.72 PMPM. The effect of including costs in the ACR that would be unallowable under Medicare principles or exceed actual costs was an inflated administrative amount that reduced the amount available to Medicare beneficiaries for additional benefits, reduced premiums, or cost sharing.

In responding to our prior report, CMS stated that its revised ACR methodology should result in (1) more accurate administrative costs for Medicare beneficiaries and (2) a lesser amount of administrative costs being allocated to Medicare enrollees. We agree that the revised methodology improved the prior version; however, we believe that more can be done to reduce the administrative cost burden on the Medicare program. However, we believe our prior recommendations, if implemented, would improve on this situation.

If you have any questions, please contact me or George M. Reeb, Assistant Inspector General for Health Care Financing Audits, at (410) 786-7104.

Please refer to Common Identification Number A-03-01-00017 in all correspondence related to this summary report.

Attachment

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**SUMMARY RESULTS OF REVIEW OF
THE ADMINISTRATIVE COST
COMPONENT OF THE ADJUSTED
COMMUNITY RATE PROPOSAL AT TEN
MEDICARE+CHOICE ORGANIZATIONS
FOR THE 2000 CONTRACT YEAR**



**JANET REHNQUIST
Inspector General**

**NOVEMBER 2001
A-03-01-00017**

EXECUTIVE SUMMARY

OBJECTIVE

The objective of our reviews was to determine if the costs included in the administrative component of the contract year (CY) 2000 adjusted community rate (ACR) proposals submitted by 10 managed care organizations (MCO) that participated in the Medicare+Choice (M+C) program were appropriate when compared to the Medicare program's general principle of paying only reasonable costs. This report includes audit results of 10 MCOs, one each located in Florida, Nevada, New Jersey, New York, Ohio, Pennsylvania, Texas, and Washington, and two located in Missouri.

BACKGROUND

Through the ACR proposals, MCOs present to the Centers for Medicare & Medicaid Services (CMS) an initial rate that represents the "commercial premium" the organization would charge its non-Medicare enrollees for services included in the managed care plan. This initial rate is then adjusted by various factors described in the regulations, including the relative costs to Medicare beneficiaries, to establish an appropriate payment rate that reflects the characteristics of the Medicare population. The accuracy of the specific parts of the ACR proposal is critical to ensuring that MCOs receive appropriate payments that are consistent with their commercial premiums. The ACR proposal also provides a mechanism for the MCO to provide additional benefits to Medicare beneficiaries or to credit the program if payments received exceed the properly adjusted commercial rate. Administrative costs, which are one component of the ACR, include non-medical costs associated with occupancy, marketing, sales, reinsurance, and compensation.

In an Office of Inspector General (OIG) audit report issued in January 2000¹, we identified \$66.3 million of inappropriate administrative costs that were included in the ACRs submitted by nine MCOs. These costs would have been unallowable had CMS required the MCOs to follow Medicare's general principle of paying only reasonable costs. The former CMS Administrator requested OIG to examine additional MCOs' administrative costs. However, she wanted the reviews performed at MCOs who submitted ACRs under the revised ACR format. This report summarizes our response to CMS's request and will, hopefully, be useful to you in working with the MCOs.

FINDINGS

The summary of our 10 MCOs' administrative costs audits showed that \$97.1 million of base year costs would have been recommended for disallowance had the MCOs been required to follow the Medicare program's general principle of paying only reasonable costs. As you know, since there is no statutory or regulatory authority governing allowability of costs in the ACR, the MCOs were not required to adhere to this principle. The \$97.1 million of costs included:

¹ Review of the Administrative Cost Component of the Adjusted Community Rate Proposal at Nine Medicare Managed Care Organizations for the 1997 Contract Year (A-03-98-00046).

- \$46.3 million in unresolved costs reported by seven MCOs resulting from \$45.0 million of related party transactions that were not based on incurred costs and \$1.3 million of insufficiently documented costs;
- \$45.3 million in questionable allocations reported by eight MCOs resulting from improper allocations of non-Medicare costs to the Medicare line of business and/or excessive cost allocations that would have been disallowed had CMS required MCOs to follow the Medicare cost contract criteria which required that indirect costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment; and
- \$5.5 million for costs unallowable under the Federal Acquisition Regulation (FAR) part 31 Contract Cost Principles and Procedures which other Medicare organizations, not MCOs, are required to follow². The costs related to entertainment, gifts, and employee morale; lobbying and legal expenses; public relations; taxes; bad debts; contributions and sponsorships; and miscellaneous items. All 10 MCOs reported at least 1 of these cost elements.

Based on our audit results, we removed what would have been unallowable costs (as noted above) and recalculated the ACRs. Our adjustments reduced the CY 2000 estimated Medicare administrative costs at eight MCOs (we were unable to determine adjustments for two of the MCOs) by an average of \$32.74 per member per month (PMPM). In comparison, the estimated average cost of the additional benefits offered for CY 2000 by these MCOs equaled \$34.72 PMPM. The effect of including costs in the ACR that would be unallowable under Medicare principles or exceed actual costs was an inflated administrative amount that reduced the amount available to Medicare beneficiaries for additional benefits, reduced premiums, or cost sharing.

In responding to our prior report, CMS stated that its revised ACR methodology should result in (1) more accurate administrative costs for Medicare beneficiaries and (2) a lesser amount of administrative costs being allocated to Medicare enrollees. We agree that the revised methodology improved the prior version; however, we believe that more can be done to reduce the administrative cost burden on the Medicare program. However, we believe our prior recommendations, if implemented, would improve on this situation.

²The FAR is the primary regulation for use by all Federal Executive agencies in their acquisition of supplies and services with appropriated funds. Part 31 contains cost principles and procedures for (a) the pricing of contracts, subcontracts, and modifications to contracts and subcontracts whenever cost analysis is performed and (b) the determination, negotiation, or allowance of costs when required by a contract clause.

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INTRODUCTION

Background

Under Title XVIII of the Social Security Act, the Medicare program provides health insurance to those aged 65 and over and those who have permanent kidney failure and certain people with disabilities. Within the Department of Health and Human Services, the Medicare program is administered by CMS.

Medicare is comprised of two related health insurance programs, Part A (hospital insurance) and Part B (supplementary medical insurance), and one health delivery program, Part C (the M+C program). Part A helps pay for care in inpatient hospitals, skilled nursing facilities, rehabilitation, home health, and hospice services. Part B helps pay for physician and outpatient hospital services and durable medical equipment. Part C provides Medicare beneficiaries with a variety of health delivery models, including managed care organizations.

Medicare Managed Care

The Balanced Budget Act (BBA) of 1997 implemented Part C of the Medicare program. Beginning in 1999, the M+C program provided eligible Medicare beneficiaries a choice to receive benefits through the original

Medicare fee-for-service program or through enrollment in an M+C plan.

Under the BBA of 1997, an M+C plan may offer one of several types of health insurance plans including: Coordinated Care Plans (CCP), Health Care Prepayment Plans (HCPP), Cost, Medical Savings Account Plans, and Private Fee-For-Service (PFFS) Plans. A CCP provides health care services through health maintenance organization plans (with or without point of service options), plans offered by provider-sponsored organizations, preferred provider organization plans, or competitive medical plans.

As of January 2000, CMS had 347 contracts with MCOs. At that time, more than 6.8 million beneficiaries were enrolled in the 347 contracts as follows: 268 CCPs, 15 HCPPs, 35 Cost, and 29 demonstration projects. As of January 2001, the number of contracts decreased to 247 with approximately 6.2 million enrollees in: 175 CCPs, 15 HCPPs, 31 Cost, 1 PFFS, and 25 demonstration projects.

In order to offer an M+C plan, MCOs must be licensed under State law as a risk-bearing entity. These organizations assume full financial risk on a prospective basis for all health care services provided. The MCOs receive advance monthly capitation payments based on the location, adjusted for risk factors such as age, disability status, and gender. All MCOs are required to provide Medicare beneficiaries at least the current Medicare benefit package (per the fee-for-service program) and the beneficiaries may also receive additional health services offered by a particular plan.

Adjusted Community Rate Proposal

Section 1854 of the Social Security Act requires MCOs to compute an ACR. At CMS central office, the Center for Health Plans and Providers reviews and

approves the submitted ACRs. Through the ACR proposals, MCOs present to the CMS an initial rate that represents the “commercial premium” the organization would charge its non-Medicare enrollees for services included in the managed care plan. This initial rate is then adjusted by various factors described in the regulations, including the relative costs to Medicare beneficiaries, to establish an appropriate payment rate that reflects the characteristics of the Medicare population. The accuracy of the specific parts of the ACR proposal is critical to ensuring that MCOs receive appropriate payments that are consistent with their commercial premiums. The ACR proposal also provides a mechanism for the MCO to provide additional benefits to Medicare beneficiaries or to credit the program if payments received exceed the properly adjusted commercial rate.

Beginning with CY 2000, CMS implemented a provision of the BBA of 1997 and required MCOs use actual costs to price the health plan benefit packages. As a result, CMS issued new instructions for completing the CY 2000 ACRs. These instructions specifically required that MCOs base their CY 2000 ACRs on the Calendar Year 1998 actual costs (the most recently completed calendar year during the preparation of the ACR). The new method also required the MCOs to separate their costs into three components - direct medical, administration, and additional revenues (e.g., profits). The prior ACR method combined the administration and additional revenues under the administration caption.

The MCOs must complete a separate ACR for each health plan benefit package offered. The ACR is calculated on a series of worksheets that accompany the ACR instructions. The ACR computation follows:

Worksheet A contains the average payment rate (APR), initial rate, and membership capacity. The APR represents the estimated premiums the MCO expects to receive from CMS during the contract period. The initial rate represents the “commercial premium” the MCO would charge its general non-Medicare population for the same type of M+C plan;

Worksheet B contains total Medicare and non-Medicare costs incurred in the base period (1998) and the relative cost ratios. The relative cost ratios are developed from the actual historical costs and represent the differences in characteristics between Medicare and non-Medicare enrollees;

Worksheet B-1 includes key financial information about the MCO to assist CMS in determining whether the MCO is financially able to support the Medicare plans offered;

Worksheet C contains the Medicare and non-Medicare premiums and cost sharing (deductibles, copayments, and coinsurance) that the MCO intends to charge;

Worksheet D reflects expected variations to the CY costs that were not accounted for in other ACR worksheets; and

Worksheet E calculates the adjusted community rate by multiplying the initial rate by the relative cost ratios and adjusting the resultant amounts by the expected variations.

The ACR is integral to pricing an MCO's benefit package, computing "excess" (if any) from Medicare capitation payments, and determining additional and supplemental benefits or premiums. Any extra Medicare funds over the cost of providing Medicare covered services (including medical and administrative costs and additional revenues is considered excess). The excess may be used to determine the extent of additional benefits offered, reducing beneficiary premiums or copayments, distributed to a benefit stabilization fund, or a combination of these.

Due to a lack of statutory or regulatory authority governing allowability of costs in the ACR process, the MCOs are allowed to include administrative costs in their ACRs not traditionally allowed under the Medicare fee-for-service program. The Medicare cost principles applicable to the fee-for-service program preclude the reporting of unreasonable, unnecessary, and unallocable costs. Additionally, regulations covering cost-based MCOs that contract with CMS on a cost reimbursement basis provide specific parameters delineating allowable administrative costs for enrollment, marketing, and other general and administrative costs that benefit the total enrollment of a cost-based plan. These regulations, however, are not used in administering M+C contracts.

Prior Office of Inspector General Report Identified Inappropriate Administrative Costs

In a prior audit report (see footnote 1), we identified \$66.3 million of inappropriate administrative costs that were included in the ACRs submitted by nine MCOs. These administrative costs would have been unallowable had the

MCOs been required to follow Medicare's general principle of paying only reasonable costs. We recommended that CMS pursue legislation concerning MCOs' administrative costs that would require MCOs to follow Medicare's general principle of paying only reasonable costs. The CMS did not concur with the recommendation and noted that it had recently revised the ACR methodology and that the new procedures would be reviewed to ensure the effectiveness of reducing the administrative burdens on the MCOs.

Objectives, Scope, and Methodology

The objective of our review was to determine if the base year administrative costs submitted by the 10 MCOs on their CY 2000 ACR proposals were reasonable, necessary, and allocable when compared to the Medicare program's general principle of paying only reasonable costs. The

criteria used for our assessment of the MCOs' administrative costs are not currently applicable in the M+C program. We applied the criteria used for cost-based MCOs and Medicare cost principles as they relate to the fee-for-service program. We did not review any medical costs reported by the MCOs.

As of January 2000, CMS contracted with 268 CCPs with enrollment of 6.2 million beneficiaries, or 91 percent of managed care enrollees. From these 268 CCPs, we judgmentally selected 10 with locations throughout the country for review. We selected one MCO each from Florida, Nevada, New Jersey, New York, Ohio, Pennsylvania, Texas, and Washington, and two from Missouri. Because we judgmentally selected the sample, we did not project the results to all CCPs. We based our recommendations on the materiality of the findings at the 10 MCOs and the fact that the findings were comparable to previous Office of Inspector General (OIG) findings.

We used each MCO's accounting records as support for the CY 2000 ACRs. Administrative costs included non-medical costs such as occupancy, marketing, sales, reinsurance, and compensation. We reviewed applicable laws and regulations and discussed with MCO officials their ACR process and how the MCOs derived the administrative costs. We judgmentally selected categories of administrative costs which traditionally have been shown to be problematic areas in the Medicare fee-for-service program. Because of this, our results cannot be considered representative of the universe of administrative costs submitted by each MCO. We evaluated the selected costs against the cost principles of the Federal Acquisition Regulation (FAR) part 31 and 42 CFR. Based on our results, we revised the base year administrative costs and recomputed the administrative costs in the ACRs.

We performed the 10 reviews in accordance with generally accepted government auditing standards. These reports are available on the world wide web at www.oig.hhs.gov. Our review objectives did not require us to review the internal control structure at the MCOs. We conducted audit work at each of the MCO's offices and in OIG regional and field offices. We provided reports describing the audit results to CMS and each of the MCOs.

DETAILS OF ISSUES NOTED

Actual Administrative Costs Included Costs Generally Considered Unallowable

Under the existing ACR methodology, there is no statutory or regulatory authority governing the allowability of costs in the ACR for MCOs, unlike other areas of the Medicare program. For example, when preparing their ACR proposals, MCOs are not required to adhere to cost principles that preclude the reporting of unreasonable, unnecessary, and unallocable costs. Also, regulations covering cost-based MCOs provide specific parameters delineating allowable administrative costs for enrollment, marketing, and other general and administrative costs do not apply to M+C contracts.

Our review of the 10 MCOs' ACR proposals found that Medicare base year administrative costs totaling \$97.1 million would have been unallowable had the MCOs been required to follow Medicare's general principle of paying only reasonable costs. We identified the questionable amounts based on our reviews of the sampled administrative costs and the allocation methods used to distribute the costs to the Medicare line of business. The questionable costs included:

- \$46.3 million of unresolved costs at seven MCOs resulting from \$45.0 million in related party transactions that were not based on incurred costs and \$1.3 million in unsupported costs;
- \$45.3 million in questionable allocations reported by eight MCOs resulting from improper allocations of non-Medicare costs to the Medicare line of business and/or excessive cost allocations that would have been disallowed had CMS required MCOs to follow the Medicare cost contract criteria which required that indirect costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment; and
- \$5.5 million for costs unallowable under the FAR part 31 which other Medicare organizations, not MCOs, are required to follow. The costs related to entertainment, gifts, and employee morale; lobbying; public relations; taxes; contributions and sponsorships; bad debts; and miscellaneous items. All 10 MCOs reported at least 1 of these cost elements.

Unresolved Costs

Seven MCOs did not provide the necessary documentation to enable us to determine the appropriateness of \$46,276,881 in costs. These costs consisted of \$45,008,515 of related party costs reported by three MCOs and \$1,268,366 of unsupported administrative costs reported by seven MCOs.

Related Party Costs--\$45,008,515

Three MCOs reported related party costs of \$45,008,515 for management fees and royalty expenses paid to their parent companies. These related party expenses were based on agreements between the parent company and the MCO whereby the parent would perform certain management functions or permit the use of the trademark name for a fee from the MCO based on the MCOs revenues. While related party costs are allowable under Medicare fee-for-service, Medicare limits the provider's reimbursement to the related party's costs (42 CFR 417.536(k)). Moreover, Medicare requires cost contractors to allocate allowable costs of a separate entity or department that performs administrative services in reasonable proportion to the benefits received (42 CFR 417.564(b)(2)(i)). Because we did not have the support for the parent companies' costs, we were unable to determine whether the \$45 million in related party costs: (1) represented actual costs to the related party, (2) were distributed on the basis of benefits received or other reasonable allocation methodology, and (3) included costs that would not be allowable if existing Medicare regulations applied to MCOs.

Furthermore, we found that two of the MCOs either recently revised or were in the process of revising the agreements between the parent company and the MCO. Under the new agreements, the parent company will provide more services in exchange for a greater percentage of the MCOs' revenues. Once the agreements are implemented, the majority of the MCOs' reported administrative costs would be derived from these management fees and not actual, incurred administrative expenses. Without establishing criteria for limiting related party transactions to actual costs, CMS will not have assurance that these expenses are reasonable.

Unsupported Administrative Costs--\$1,268,366

Seven MCOs did not provide adequate supporting documentation for \$1,268,366 in administrative costs. According to FAR 31.201-2, contractors are responsible for maintaining adequate supporting documentation to demonstrate that costs claimed are allocable and comply with applicable cost principles. If the MCOs had been required to follow this criteria, we would have disallowed these costs due to lack of supporting documentation.

For example, one MCO reported \$650,561 for various legal, public relations, purchased services, losses, and consultants but provided no support to justify the charges. Another MCO did not provide any support for \$387,078 of costs allocated to Medicare. The costs included legal and consulting fees, memberships and dues in various organizations, travel expenses, and investment services. Additionally, one MCO provided incomplete support for travel expenditures and could not provide invoices for several administrative costs. Unsupported costs at this MCO totaled \$73,638.

Misallocated Costs

We identified a total of \$45,301,892 in costs reported by eight MCOs that should not have been allocated to the Medicare program.

Excessive Allocation--\$35,520,106

Five MCOs used allocation methods that resulted in excessive charges to Medicare. These five MCOs did not maintain separate accounting records for their Medicare and non-Medicare administrative costs. To complete the ACRs, the MCOs assigned administrative costs to the business lines based on allocation calculations. For example, four of the MCOs allocated administrative costs to Medicare based on Medicare's percentage of total revenues. The fifth MCO used the number of months that individuals were enrolled in the plans, but the MCO weighted the Medicare months using unreasonable estimates. Under 42 CFR 417.564(a), cost contractors are required to apportion indirect costs based on a ratio of Medicare enrollment to total enrollment. The CMS does not require M+C plans to follow this criteria. One of the MCOs included in our review apportioned its indirect costs on the ratio of Medicare enrollment to total enrollment. This MCO felt that this was an appropriate methodology.

Using the criteria for cost-based contractors, we recalculated the allocated costs of the five MCOs that used alternative allocation methods and determined that the allocation methods resulted in excessive charges to Medicare. The amounts allocated by the MCOs to the Medicare line of business exceeded our calculations by over \$35.5 million.

For example, one MCO allocated \$10.1 million in excessive administrative costs using an allocation ratio of Medicare revenues to total revenues. Using this approach, the MCO allocated nearly 50 percent of its administrative costs to Medicare. We applied the criteria in 42 CFR 417.564(a) and recalculated the MCO's allocated costs using the percentage of Medicare enrollment (21 percent) to total enrollment. We found that had the MCO been required to follow this criteria, it would have decreased its allocation by \$10,093,005.

Similarly, another MCO reported \$9.3 million in excessive administrative expenses by apportioning administrative costs based on revenue rather than enrollment. This MCO allocated approximately 27 percent of its administrative costs to Medicare and 73 percent to its non-Medicare lines of business. However, only about 10 percent of the enrollees were Medicare beneficiaries, and 90 percent of the enrollees were enrolled in non-Medicare plans. Consequently, Medicare was allocated about 27 percent of the administrative costs even though Medicare accounted for only about 10 percent of the enrollees. Had CMS required MCOs to follow the criteria mandating the apportionment of general administrative expenses based on enrollment, this MCO's Medicare costs would have decreased by \$9,297,627.

Costs Allocated to Wrong Line of Business--\$9,781,786

Additionally, we found that eight of the MCOs allocated \$9.8 million of costs to Medicare that did not relate to Medicare. According to FAR 31.201-4, a cost is allocable if it (a) is incurred specifically for the contract; (b) benefits both the contract and other work, and can be distributed in reasonable proportion to the benefits received; or (c) is necessary to the overall operation of the business. Of the \$9.8 million:

- Two MCOs reported \$7.8 million in broker commissions for its commercial lines of business. However, broker commissions are service fees paid to agents for soliciting and securing enrollees in the MCO's non-Medicare business.
- One MCO reported \$1.8 million in premium taxes. The tax did not relate to Medicare.

Allocation errors can have a significant effect when developing the ACR. Specifically, using the ACR methodology, administrative costs are developed by multiplying the estimated CY administrative costs for the non-Medicare business by a relative cost ratio. This ratio is based on actual administrative costs incurred for Medicare beneficiaries in the base year relative to actual administrative costs incurred for non-Medicare enrollees in the same base year. Therefore, an allocation error resulting in an overcharge to Medicare and an undercharge to non-Medicare costs will inflate the relative cost ratio and lead to an inflated Medicare administrative cost rate.

Administrative Costs Unallowable Under the FAR

We identified \$5,499,049 of administrative costs that did not comply with guidelines that CMS requires other Medicare program participants to follow. The guidelines, FAR part 31, define principles and procedures for determining the allowability of specific costs. We categorized these costs as follows.

Entertainment, Gifts, and Employee Morale Costs--\$622,029

Nine MCOs included \$622,029 in their accounting records for costs related to entertainment, gifts, and employee morale. Three of the MCOs accounted for about \$481,903 of this amount while the remaining six MCOs reported costs ranging from \$6,440 to \$42,679. Examples of these costs are:

- \$284,825 in entertainment costs which included stadium skyboxes, tickets to concerts and sporting events, and golf tournaments by one MCO,
- \$90,136 at two MCOs for golf club memberships and dues,
- \$30,445 for a Christmas party at one MCO, and
- \$3,452 for costs of alcohol at various functions at two MCOs.

Medicare fee-for-service contractors are prohibited from claiming these types of costs by three provisions of the FAR. According to FAR 31.205-13(b), (c), and (d), costs of employee gifts and recreation and losses sustained for food services furnished without charge are unallowable. Section 205-14 states that costs of amusement, diversion, social activities, and any directly associated costs, such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities are unallowable. Costs of membership in social, dining, or country clubs or other organizations having the same purpose are also unallowable. Additionally, FAR 31.205-51 strictly prohibits costs of alcoholic beverages.

Lobbying and Legal Expenses--\$165,383

Eight MCOs included lobbying and legal expenses totaling \$165,383 in the Medicare administrative costs. The eight MCOs recorded a total of \$76,543 in lobbying costs. Two of the MCOs accounted for \$42,970 of this amount while the other six MCOs reported costs ranging from \$20 to \$11,305. In prior years, CMS included a provision in the MCOs' contracts prohibiting the use of Medicare funds to influence legislation or appropriation. This contract provision incorporated FAR 31.205-22, which stated that costs associated with lobbying and political activity were unallowable. The CY 2000 contracts did not contain this provision.

Additionally, one MCO that recorded lobbying expenses also reported \$88,840 of legal expenses for a lawsuit filed with the MCO's State of incorporation. Legal costs are prohibited under FAR 31.205-47(b) and (g) which states that costs incurred in connection with any proceeding brought by a State government are unallowable and should be segregated and accounted for separately.

Public Relations Costs--\$694,521

Seven MCOs reported public relations costs of \$694,521 in their accounting records. Two of the MCOs accounted for \$603,210 of this amount while the other five MCOs reported costs ranging from \$1,503 to \$31,592. The public relations costs included charges for radio and television announcements for a separate entity, promotional giveaways including clothing and novelties with the company's logo, and souvenirs. According to FAR 31.205-1(f) unallowable public relations and advertising costs include the following: (1) disseminating messages calling favorable attention to the contractor for purposes of enhancing the company image and (2) costs of imprinted clothing, other mementos, and souvenirs.

Taxes--\$2,403,297

One MCO recorded taxes of \$2,403,297 in its accounting records. These costs related to the MCO's Federal income tax expense. The FAR 31.205-41 states that Federal income taxes are not allowable.

Bad Debts--\$1,205,708

Four MCOs reported \$1,205,708 in bad debt costs. These costs are unallowable under FAR 31.205-3. This section states that bad debts, including actual or estimated losses arising from uncollectible accounts receivable due from customers and other claims, and any directly associated costs such as collection costs and legal costs, are unallowable.

Contributions and Sponsorship Costs--\$217,809

All 10 MCOs reported contributions and sponsorship costs totaling \$217,809. Four of the MCOs accounted for nearly 75 percent of the costs, or about \$153,819, and the remaining six MCOs reported costs ranging from \$49 to \$19,765. Contribution and sponsorship expenditures included donations to charitable organizations such as the March of Dimes, the United Way, and various social events and awards celebrations. Several MCOs also reported sponsorship costs for golf tournaments and other sporting events. The FAR 31.205-8 and 205-1(f)(3) prohibit such costs. Specifically, contributions or donations, including cash, property and services, regardless of recipient and costs of sponsoring special events when the purpose of the event is other than disseminating technical information, are unallowable.

Miscellaneous Costs--\$190,302

Six MCOs reported other types of unallowable costs totaling \$190,302. For example, one MCO reported \$65,180 for the amortization of goodwill. According to FAR 31.205-49, "Costs for amortization...of goodwill (however represented) are unallowable." One MCO reported \$40,898 for staff meals and accounting errors that we deemed unreasonable using FAR 31.201-3(b)(4) which stated that reasonableness depends upon various considerations including significant deviations from the contractor's established practices. Another MCO reported \$34,251 in out-of-period costs related to amounts incurred in 1997 and 1999 (not the 1998 base year). Under FAR 31.203(e), the base period for allocating costs is the accounting period during which such costs are incurred and accumulated for work performed in that period.

Conclusion

By including the questionable costs in the ACRs, the MCOs increased their estimated 2000 Medicare administrative costs by an average of \$32.74 PMPM³.

To illustrate the effect to the Medicare beneficiary, we calculated both the average estimated cost of additional benefits offered and the average estimated cost sharing. We calculated that the estimated cost of the additional benefits offered by the MCOs averaged \$34.72 PMPM⁴. The additional benefits offered included prescription drugs, eye exams and glasses, hearing exams and aids, and dental benefits. Had CMS required the MCOs to follow Medicare's general principle of paying only reasonable costs, the MCOs could have increased the additional benefits 94 percent (\$32.74 PMPM /\$34.72 PMPM).

As an alternative effect to the calculations we noted above, we also calculated that the estimated cost sharing, including premiums and copayments ranged from \$3.98 PMPM to \$105.36 PMPM and averaged \$35.05 PMPM⁵. Had CMS required the MCOs to follow Medicare's general principle of paying only reasonable costs, the MCOs could have reduced premiums charged to Medicare members by approximately \$32.74 PMPM. For those MCOs that charged no premium or a premium less than \$32.74 PMPM, the MCOs could have offered their Medicare members additional benefits and reduced premiums.

Our previous audit work concluded that MCOs have been allowed to include administrative costs on their ACRs that we would have questioned had the MCOs been required by CMS to follow Medicare's general principle of paying only reasonable costs. This report supports that conclusion. For CY 2000, the base year costs reported by the 10 MCOs reviewed included

³The \$32.74 represents a weighted average of the modified ACR (per Worksheet E) for eight MCOs. We could not determine the effect on Worksheet E for two of the MCOs that represented approximately 21 percent of the total enrollment for the MCOs that we reviewed. Therefore, we excluded them from our calculations.

⁴The \$34.72 PMPM represents a weighted average of the Worksheet E values of the additional benefits for eight of the MCOs reviewed in which we could calculate a modified ACR per footnote 3 above.

⁵The cost sharing ranges and average represent the Worksheet E Actual Charges for the basic Medicare package for eight of the MCOs reviewed in which we could calculate a modified ACR per footnote 3 above.

\$97.1 million that would have been unallowable under Medicare's general principle of paying only reasonable costs. The CMS previously stated that its revised ACR methodology should result in (1) more accurate administrative costs for Medicare beneficiaries and (2) a lesser amount of administrative costs being allocated to Medicare enrollees. We agree that the revised methodology is an improvement over the prior version; however, we believe that more can be done to ensure that Medicare administrative costs of MCOs are limited to reasonable costs. We believe our prior recommendations, if implemented, would improve on this situation.