DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date: OCT 1 1993

From: Bryan B. Mitchell
Principal Deputy Inspector General

Subject: Audit of Administrative Costs Claimed Under Parts A and B of the Health Insurance for the Aged and Disabled Program by Associated Insurance Companies, Inc. (A-05-93-00054)

To: Bruce C. Vladeck
Administrator
Health Care Financing Administration

This memorandum is to alert you to the issuance on October 4, 1993 of our final report. A copy is attached.

The firm of Sheffield, Dallmann and Haley, Ltd., under contract with the Office of Inspector General, conducted an audit of Medicare administrative costs claimed by Associated Insurance Companies, Inc. (contractor). The audit covered costs claimed on the contractor's final administrative costs proposals (FACP) for Fiscal Years (FY) ended September 30, 1987 through 1989. Amounts audited were $22,018,056 for Part A and $45,378,523 for Part B.

Of the total amounts claimed, auditors considered approximately $3.8 million to be unallowable. The auditors also recommended that the contractor's FACPs for FYs 1987 through 1989 be increased by approximately $.4 million because of allowable costs which were not claimed. Included in the amounts recommended for adjustment were understated complementary insurance credits, costs improperly allocated to Medicare, and unallowable cost items.

The contractor concurred with a number of items, but did not agree with about $3.4 million of the amount questioned. The Health Care Financing Administration regional office withheld comment until issuance of our final report.

For further information, contact:

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Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

AUDIT OF ADMINISTRATIVE COSTS CLAIMED UNDER PARTS A AND B OF THE HEALTH INSURANCE FOR THE AGED AND DISABLED PROGRAM FOR THE PERIOD OCTOBER 1, 1986 THROUGH SEPTEMBER 30, 1989

ASSOCIATED INSURANCE COMPANIES, INC.
INDIANAPOLIS, INDIANA

SEPTEMBER 1993 A-05-93-00054

SUMMARY

Blue Cross and Blue Shield Association (BCBSA) entered into an agreement with the Secretary of the Department of Health and Human Services (DHHS) to participate as a Medicare intermediary in administering the Medicare program. Under a subcontract with BCBSA, Associated Insurance Companies, Inc. (the Contractor), receives, reviews, audits, and pays Medicare A claims. In addition, under an agreement with DHHS, the Contractor participates as a Medicare carrier in administering the Medicare B program. The Contractor is reimbursed for all reasonable and allowable costs that are not specifically limited by the Medicare agreements. Allowable costs are determined in accordance with Federal Acquisition Regulation (FAR) Part 31, as interpreted and modified by Appendix B to the Medicare agreements.

Our examination was made in accordance with generally accepted auditing standards and *Government Auditing Standards* (General Accounting Office, 1988), published by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance that the final administrative cost proposals (FACP) are free of material misstatement. Our audit also included an evaluation of the accounting system and related internal controls, and the application of the auditing procedures contained in DHHS Interim Audit Instruction, E-1 revised, Part One, dated May 1981.

The period covered by the examination was October 1, 1986 to September 30, 1989. During this period, the Contractor claimed $22,018,056 (Part A) and $45,378,523 (Part B) for administering the Medicare programs. We recommend that the Contractor adjust its FACPs by $1,335,188 (Part A) and $2,020,372 (Part B) to eliminate unallowable and unallocable costs charged to the Medicare programs. The major audit findings are briefly discussed below. A more detailed explanation of each finding appears in the Findings and Recommendations section of this audit report.

- The Contractor understated its complementary insurance program credits by $1,863,834 because the methodology used to calculate the cost to be attributed to each crossover claim did not include all of the claims processing related cost centers.

- The Contractor claimed $658,227 of unallowable costs that were either charged to the Medicare programs in error or allocated based on inequitable or unsupported allocation methods.

- The Contractor claimed $462,391 of unallowable automobile costs which were either not related to actual business usage or unsupported.

- The Contractor claimed $327,284 of unallowable professional and consulting costs that benefitted its affiliates and its non-Medicare lines of business.

- The Contractor did not claim ($253,497) of allowable return on investment costs (ROI) due to the use of estimates

- The Contractor did not properly increase its costs by $(23,426) for losses recognized on the sale of depreciable assets.

- Overallocations and duplicate charges caused the Contractor to claim $131,051 of unallowable deferred compensation costs.

- The Contractor claimed $62,168 of unallowable interest costs.

- The Contractor claimed $55,451 of unallowable taxes that were allocated based on budgeted as opposed to actual amounts.

- The Contractor claimed $44,547 of unallowable costs related to advertising, social club dues, entertainment, travel and contributions.

- The Contractor claimed $27,530 for an excessive severance payment to a corporate officer.

- The Contractor claimed $145,285 of costs in Fiscal 1989 which were related to 1988. 1988 costs have been increased and 1989 decreased by the $145,285.

- The Contractor claimed Indiana gross income taxes (IGIT) based on gross Medicare receipts. Because the findings in this report will reduce the fiscal year gross receipts the IGIT should be reduced accordingly. We did not compute a recommended adjustment because it should be based on sustained findings.

Contractor responses to the proposed adjustments, in the order presented are summarized as follows; Complementary Insurance - the Contractor disagrees with the proposed adjustment of $1,863,834; Inequitable or unsupported allocation methods - the Contractor concurs with $(126,784) and disagrees with $785,011 of the proposed $658,227 adjustment; Automobile Costs - the Contractor disagrees with the proposed $462,391 adjustment; Professional and Consulting Costs - the Contractor agrees with $211,233 of the proposed $327,284 adjustment; Return on Investment Costs - the Contractor agrees with the proposed $(253,497) adjustment; Losses on the Sale of Assets - the Contractor agrees with the proposed $(23,426) adjustment; Deferred Compensation - the Contractor disagrees with the proposed $131,051 adjustment; Interest - the Contractor agrees with $18,325 of the proposed $62,168 adjustment; Taxes - the Contractor agrees with the proposed $55,451 adjustment; Advertising, Social Club Dues, Entertainment, Travel and Contributions - the Contractor agrees with $42,752 of the proposed $44,547 adjustment; Excessive Severance Payment - the Contractor disagrees with the proposed $27,530 adjustment; Reclassification - the Contractor agrees with only part of the reclassification. In total the Contractor concurs with $(75,946) and disagrees with $3,431,506 of the proposed $3,355,560 in adjustments.

We evaluated the Contractor's system of significant internal accounting and administrative controls, and compliance with laws and regulations that can materially affect the Contractor's FACPs. Based on our study of the significant control elements required by DHHS, we believe that the Contractor's procedures for segregating unallowable and unallocable costs were not adequate for DHHS purposes because of the conditions described above, which we believe are material weaknesses in relation to the agreements to which this report refers. Our review on compliance disclosed that except for certain material instances of noncompliance with FAR Part 31 and the Medicare agreements, the Contractor complied with the terms and provisions of laws and regulations for the transactions tested. The Sheffield Dallmann & Haley, Ltd reports on internal control and compliance and its opinion on the FACPs appear later in this report.

CONTENTS

INTRODUCTION

BACKGROUND

Health Insurance for the Aged and Disabled (Medicare), title XVIII of the Social Security Act, as amended, is a broad program of health insurance that became effective in July 1966. For certain disabled individuals and individuals aged 65 or over, Title XVIII, Part A, provides a basic insurance plan covering hospital costs and related care. For these same individuals, Title XVIII, Part B, provides a voluntary insurance plan covering physician costs and other health services.

The Health Care Financing Administration (HCFA) administers the Medicare program. Under an agreement with the Secretary of the Department of Health and Human Services (DHHS), Blue Cross and Blue Shield Association (BCBSA) participates as a Medicare intermediary to assist in program administration. Under a subcontract with BCBSA, Associated Insurance Companies, Inc. (the Contractor), receives, reviews, audits, and pays Medicare A claims. In addition, the Contractor has an agreement with DHHS to participate as a Medicare carrier. Under this agreement, it receives, reviews, audits, and pays Medicare B claims. Subject to limitations specified in the agreements, the Contractor is entitled to reimbursement for allowable administrative costs incurred.

Fiscal Year (FY) 1989 Medicare agreements did not contain any cost reimbursement limitations. FY 1987 and 1988 Medicare agreements contained unit-cost target rates for each bill (Part A) and claim (Part B) processed for the following FACP operations:

- o <u>Part A</u>
  Bills Payment
  Reconsideration and Hearings

- o <u>Part B</u>
  Claims Payment
  Reviews and Hearings
  Beneficiary/Physician Inquiry

From October 1, 1986, through September 30, 1989, the Contractor processed 25,368,630 Medicare claims. During this period, the Contractor claimed $67,396,579 for administering Parts A and B of the Medicare program.

Costs incurred in connection with Contractor activities are accumulated in cost centers and subsequently allocated to various lines of business, including Medicare.

REGULATIONS RELATING TO COST REIMBURSEMENT

The Medicare agreements, Articles XIII (Part A) and XV (Part B) state that allowable costs under the agreement shall be determined in accordance with Federal Acquisition Regulation (FAR) Part 31, as interpreted and modified by Appendix B to the agreements. The FAR 31.201-1 states that the total contract cost is the sum of the allowable direct and indirect costs allocable to a contract, incurred or to be incurred, less any applicable credits.

The FAR Part 31 also states that charges are allowable if tests of reasonableness and allocability are met and generally accepted accounting principles are followed. A reasonable cost is defined as one that would be incurred by a prudent person conducting competitive business. Further, a cost is allocable if it is assignable or chargeable to a particular cost objective in reasonable proportion to the benefits received.

FAR 31.202 and 31.203 define direct and indirect costs as follows:

- o **Direct Costs**: Any cost that can be identified specifically with a particular cost objective. Costs identified specifically with the contract are direct costs of the contract and are to be charged directly thereto. Costs identified specifically with other work of the Contractor are direct costs of that work and are not to be charged to the contract directly or indirectly.

- o Indirect Costs: Any cost that, because of its incurrence for common or joint objectives, is not readily subject to treatment as a direct cost.

SCOPE OF AUDIT

We audited the Contractor's final administrative cost proposals (FACP) from October 1, 1986, through September 30, 1989. The FACPs are the responsibility of Contractor management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* (General Accounting Office 1988), published by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance that the FACPs are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the FACPs. It also includes assessing the accounting principles used and significant estimates made by management and evaluating the overall FACP presentation. Our audit also included an evaluation of the accounting system and related internal controls, and the application of the auditing procedures contained in DHHS Interim Audit Instruction, E-1 revised, Part One, dated May 1981. We believe that our audit provides a reasonable basis for our opinion.

The Contractor prepared the FACPs to present allowable costs incurred under the Medicare agreements in accordance with FAR Part 31 and the terms and conditions of the agreements; these FACPs are not intended to be a complete presentation of the Contractor's revenues and expenses.

The period covered by the examination was October 1, 1986, to September 30, 1989. Audit fieldwork was conducted at Associated Insurance Companies, Inc., Indianapolis, Indiana. We completed our onsite review on January 27, 1993.

This report is intended solely for the purpose described above and should not be used for any other purpose.

FINDINGS AND RECOMMENDATIONS

The Findings and Recommendations resulting from the audit are described in this section.

COMPLEMENTARY INSURANCE CREDITS

The Contractor understated its complementary insurance program credits, thereby overstating its FACPs by $534,239 for the fiscal year ended September 30, 1987 and by $699,324 and $630,271 for the fiscal years ended September 30, 1988 and 1989 respectively.

Although the Contractor developed a methodology to allocate to its private business the cost of processing its complementary insurance claims, the estimated rate per claim was not adjusted to actual at the year ends. In addition our review of the contractors methodology of developing its per claim crossover rates indicated that certain cost centers and items of overhead that should have been included in the calculations, per the Contractor's Medicare intermediary manual, had not been included, thereby understating the credit amounts.

Section 1601.c of the Contractors Medicare intermediary manual states:

> ...charges to the complementary insurer are determined by cost allocation. As used in this section, the term allocation means to distribute all costs to Medicare and complementary insurance in such proportion as to reflect the benefits received by each program. In selecting the appropriate method of allocation consider the benefits derived from each function. Where mutual benefits are derived full cost sharing is required....
>
> When allocating costs to complementary insurance, observe the following principles:
>
> o Charge all direct costs to the appropriate line of business.
>
> o Prorate indirect costs on an appropriate basis subject to audit.

At our request the Contractor recalculated its complementary claim rates using actual as opposed to estimated amounts for each Part (A and B) for each fiscal year. The Contractor's methodology was to begin with line 1 per the FACPs and to subtract costs incurred subsequent to the crossover and costs it believed not to be related to the claims process.

We reviewed the Contractor's workpapers and added back those costs which we believed to be a part of the claims process and as such removed in error. We also added costs related to the Medicare Secondary Payer function and the prepayment costs related to the medical and utilization review process which we believe benefit the complementary insurer and should be part of claims processing cost allocated to the complementary claim. The proposed adjustments are the result of subtracting the rates originally claimed from the newly calculated rates and multiplying times the number of claims processed.

The understatement of complimentary insurance credits caused the following overstatement of the FACPs.

	Fiscal Year Ended September 30			
	1987	1988	1989	Total
Part A	$223,047	$194,004	$189,740	$ 606,791
Part B	311,192	505,320	440,531	1,257,043
	$534,239	$699,324	$630,271	$1,863,834

Recommendation

We recommend the Contractor decrease the FACPs by the above amounts.

Contractor Response

The Contractor disagrees with the entire $1,863,834 adjustment. It states the Complementary credit rates used in these fiscal years are actual cost based and reasonable in relation to the instructions in the manuals.

In general the Contractor states it has a partially integrated process with a tape transfer of claims records. As such the Contractor does not believe the following costs should be included in the complementary credit rate calculation: the batching of claims and the preparation of Medicare forms, provider training, the implementation of system changes, materials and supplies, return on investment, photocopy costs, travel costs, telephone costs postage costs, Medical Review costs and Medicare Secondary Payor Costs. The Contractor also believes that claim deletes and adjustments should be included in the workload count.

Auditor's Additional Comments

We will address each of the points in the Contractor's response in the order which they appear.

First, the Contractor claims that their complementary insurance process is partially integrated. However, they have indicated in part I.a. of their attached response to this finding that they prepare a tape transfer of claim records for the complementary insurer. Section 1601 B.3. of the Contractors Medicare Intermediary Manual specifically states that a tape transfer is a totally integrated process. Once it is determined to be a totally integrated process the manual requires that charges to the complementary insurer be determined by cost allocation.

Second, the Contractor believes that certain cost centers which batch claims, provide training to providers to improve efficiency and completeness of submitted claims, photocopy claims and implement mandated HCFA system or administrative changes which may have an impact on efficiency and/or payment policy should not be included in the allocation of costs to the complementary insurer. In addition, they feel that costs for materials and supplies, return on investment, travel and various other overhead expenses do not benefit the complementary insurer in any manner. The Contractor appears to be of the belief that any cost that is not incurred for the actual tape transfer should not be allocated to the complementary insurer. The Contractor fails to understand that if there was no tape transfer and all claims for Medicare supplementary policies were submitted in paper form, the complementary insurer would have to incur all of the costs mentioned above. The tape transfer is both convenient and efficient for the complementary insurer and it is only equitable that they share the costs associated with the information provided to them.

Third, the contractor points out that complementary insurance pays only the deductible and/or coinsurance amounts which the Medicare program deducts from its final payment. They believe that because of this there is no need to include Medicare Secondary Payor and Medical Review expenses in the calculation of the crossover credit. We believe that there is no question that prepayment Medical Review functions benefit the complementary insurer and the costs associated with them must be shared. Since the complementary insurer pays the coinsurance amount, that portion of the claim (20 percent) Medicare requires the beneficiary to pay, any time a medical review function discloses an unnecessary cost and excludes it from Medicare's final payment, the complementary insurer saves its 20 percent share of that cost. Our inclusion of Medicare Secondary Payor costs was mandated by an Office of Inspector General, Office of Audit Services, Region III audit guide.

Finally, the contractor is of the opinion that claim deletes and adjustments should be included in the workload counts used in the calculation of the complementary insurance credit rate. We believe that costs associated with claim deletes and adjustments are part of the normal processing costs and should be shared evenly by all adjudicated claims. It would be impossible to determine whether or not specific deleted or adjusted claims, which when finally adjudicated, were part of the tape transfer of claim records sent to the complementary insurer. Therefore, by not including them in the denominator of our complementary credit calculation, we have spread their cost evenly.

COST CENTER ALLOCATION

The Contractor (under) over charged the Medicare programs by ($184,727) in the Fiscal Year ended September 30, 1987 and by $241,742 and $601,212 for the Fiscal Years 1988 and 1989, respectively, due to either inappropriate or unsupported allocations. The proposed adjustments are the result of 1) the recalculation of cost center allocation methodologies 2) the removal of a duplicate credit 3) the adjustment of cost centers from budget to actual 4) the disallowance of cost centers related to the Contractor's private lines and 5) the disallowance of unsupported allocations.

1) The recalculation of cost center allocation methodologies:

cc10002 Board of Directors - an oversight cost center; this cost center was reallocated to all markets for Fiscal 1987 and 1988. The 1989 allocation was adjusted by the Contractor and was appropriate
Proposed disallowance $18,118

cc24515 Executive Compensation - a new cost center in fiscal 1989. Allocated equally to all markets. Reallocated based on the specific identification of the individuals in the cost center
Proposed disallowance 275,803

cc23000 Public Relations - reallocated to all markets after removing advertising account. All years affected
Proposed disallowance 33,304

ccVarious - Government Data Center - reallocated in 1988 to include all functions receiving services and to correct for $48,000 mathematical error
Proposed disallowance 91,086

Total reallocations $418,311

2) Removal of duplicate credit:

cc30001 EVP pool - This cost center was removed as non-Medicare related in the Contractor's Fiscal 1985, 1986 audit. In 1987 the Contractor realized its error and removed all of the 1987 charges plus the misallocations from Fiscal 1985 and 1986. The result was a credit to the Medicare programs for costs already removed by audit. The credit is being reinstated. $(271,985)

3) Budget to actual recalculations:

cc24514 Executive Benefits - Fiscal 1988 and 1989 only. A new cost center in 1988
Proposed disallowance $ 6,112

cc24200 Fleet Vehicle Services - Fiscal 1987 only
Proposed disallowance 9,185

Total budget to actual reallocations $15,297

4) Cost centers allocated to Medicare but related only to its private lines of business:

cc23100 Public Affairs		$91,070
cc23001 Sponsorship Winter Olympics		13,306
cc26300 Cash management		24,740
cc24307 On Site Parking and Security		6,304
cc23005 Fed Pac		1,500
cc26120 Group Controller-Subsidiaries		2,822
cc24536 Executive Loaned		2,386
cc31480 Consumer		1,576
cc31490 National		165
cc31495 Internal Audit Market Services		2,801
cc31530 New Products		1,674
cc3500 Corporate Development		152
	Total unrelated	$148,496

5) Unsupported allocations:

cc24531 Staffing - No support for a 342% increase to Part A and a 242% increase in allocations to Part B for Fiscal 1989. The cost center allocation input document (CAID) describes the allocation methodology as based on productive hours		146,535
cc26140 Corporate Analysis and I - No support for allocation percentages on 1986 CAID		4,942
cc24100 Corporate Services Administration - Cost center description says responsible for traffic, cafeteria, Market Square Garage, fleet vehicle services, security. Allocation method to all markets. Although the Medicare programs moved from downtown Indianapolis prior to Fiscal 1987, there was no decrease in the allocation. In addition, the allocations actually increased in Fiscal 1988 and 1989 to as high as 11.37% to Part B with no support or indication of change in the CAID.		114,399
cc31340 Commercial Market Services - CAID description and cost center title indicate a private lines cost center. No support for Medicare allocation. Fiscal 1989 only.		24,471
cc31492 ISD business services - No CAID or allocation support provided		57,761
	Total unsupported	$348,108
	Total Cost Center Allocations	$658,227

The above costs are unallowable in accordance with Appendix B to the Medicare agreements and the FAR which state:

Appendix B Section XV
...The following costs are unallowable:...All direct and indirect costs which relate to the Contractor's non-Medicare business and do not contribute to the Medicare agreement/contract....

FAR 31.201-4
...A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship....

overstatements of the FACPs

	Fiscal Year Ended September 30			
	1987	1988	1989	Total
Part A	(91,672)	98,315	323,694	$330,337
Part B	(93,055)	143,427	277,518	327,890
	(184,727)	241,742	601,212	$658,227

Recommendation

We recommend the Contractor (Increase) decrease its FACPs by the above amounts.

Contractor Response

The Contractor concurs with $(126,784)of the proposed $658,227 adjustment. Individual responses by Cost Center are detailed as follows:

1) The reallocation of Cost Center allocation methodologies:

cc1002 Board of Directors - the proposed $18,118 disallowance is accepted.

cc24515 Executive Compensation - Based on additional information submitted our proposed adjustment has been reduced from $349,167 to $275,803. From a technical standpoint the Contractor agrees with the amount calculated, but disagrees with the adjustment as they do not believe the specific allocation methodology should be required. The Contractor believes that because of the oversight nature of the President's council, all salaries should be allocated based on the equal market approach.

cc23000 Public Relations - the proposed adjustment of $33,304 is accepted.

ccvarious Government Data Center _ In accordance with the Contractor's response, we have reduced our proposed adjustment by $571 representing the allocation of excluded Finance and Government Administration cost to Medicare A and B. Of the remaining $91,086 proposed adjustment the Contractor concurs with $25,664 related to a mathematical error. The Contractor disagrees with $65,422 of the adjustment which is the result of including Champus program costs in the basis used to allocate start up costs. The Contractor states that the Champus program should not be allocated any of the Government Data Centers start up costs because the program was not taken into consideration in the centers initial start up plan and because $1,285,977 of $1,481,153 in start up costs had been incurred prior to any services being provided under the Champus contract.

2) **Removal of Duplicate Credit**

cc30001 EVP pool - the proposed adjustment of ($271,985) is accepted.

3) **Budget to Actual recalculations**

cc24514 Executive Benefits - the Contractor does not agree with the adjustment stating the allocation base of productive hours was appropriate and that the basis for the audit adjustment is in error because a chargeback in January of 1989 was not properly posted to this cost center.

cc24200 Fleet Vehicle Services - the proposed adjustment of $9,185 is accepted cc23100 Public Affairs - the Contractor does not agree with the proposed $91,070 disallowance representing 100% of the dollars allocated from this cost center during the period of audit. It proposes to remove travel, entertainment and lobbying hours from the cost center and allocate it on the equal markets approach.

cc23001 Winter Olympics - the Contractor initially concurred with all but $914 of the proposed adjustment. Based on a subsequent discussion held on June 24, 1993 with the Contractor's Assistant Governmental Controller, the Contractor now accepts the entire adjustment.

cc26300 Cash Management - the Contractor concurs with $23,170 of the proposed $24,740 adjustment, stating the $1,570 difference related to Fiscal 1987 should be allowed for services performed on behalf of the Medicare programs.

cc24307 On-Site Parking and Security - the Contractor admits the allocation to the Medicare program was a clerical error, but disagrees with the $6,304 adjustment because this Cost Center supported Cost Centers that allocate to the Medicare programs.

cc23005 Fed Pac - The Contractor agrees with the $1,500 proposed adjustment.

cc26120 Group Controller Subsidiaries - the Contractor accepts the proposed $2,822 adjustment.

cc24536 Executive Loaned - the Contractor disagrees with the proposed $2,386 adjustment, stating the cost of the executive loaned to the Pan American Games was a community service and as such allowable under Section 31.205 of the F.A.R.

cc31480 Consumer and cc31490 National - the Contractor concurs with the proposed adjustments of $1,576 and $165 respectively.

cc31495 Internal Audit Market Services - the Contractor disagrees with the proposed adjustment of $2,801 stating the Cost Center supported the internal audit Cost Center and that the percent allocated to Medicare is comparable to that of internal audit.

cc31530 New Products - the Contractor disputes the $1,674 proposed adjustment stating the staff of this Cost Center were involved with the Part A implementation of the Arkansas system.

cc3500 Corporate Development - the Contractor accepts the proposed $152 adjustment.

cc24531 Staffing - the Contractor disagrees with the proposed $146,535 adjustment proposing instead a $12,591 adjustment based on a reduction of allocated costs due to the offset of fees for service charged newly formed subsidiaries.

cc26140 Corporate Analysis - the Contractor was able to find the missing support for this Cost Center's CAID document. Consequently they disagree with the proposed $4,942 adjustment.

cc24100 Corporate Services Administration - the Contractor disagrees with the proposed $114,399 adjustment stating the following allocation methodologies used are appropriate

Fiscal year	Method Used
1987	Equal distributions to all markets
1988	2% Illinois Street Garage 5% to Monument Circle Building Security then equally to 5 of 6 markets
1989	Productive hours

cc31340 Commercial Market Services - the Contractor located and submitted substantiation for the Medicare allocations. Consequently the Contractor disagrees with the proposed adjustment of $100,115.

cc31492 ISD Business Services - the Contractor has redeveloped the cost center's allocation base and provided an explanation of a portion of the cost center's duties. Consequently the Contractor disagrees with the proposed $57,761 adjustment.

Auditor's Additional Comments

cc24515 Executive Compensation - Based on additional information received, we have reduced our proposed adjustment for this Cost Center from $349,167 to $275,803. The amount is in agreement with the Contractor produced calculation found on attachment #2 page 2.
Even though the Contractor agrees with these calculations, it does not agree with the proposed adjustment stating that the equal market approach is a reasonable allocation methodology. (Please note also, that even if the equal market approach was acceptable, which it isn't, the 11.30% allocation utilized by the Contractor is improper. The equal market percentage for Fiscal 1989 was 9.52% which in itself would result in a $105,884 adjustment to this Cost Center).

We, on the other hand, believe the correctness of the specific allocation approach (the allocation percentages of each participating executives cost center), to be so elementary that we find it difficult to believe that the Contractor has not accepted the proposed adjustment. How can the allocation of 100% of an individual's salary be based on attending between four to six meetings a year (attachment #2, page 1) when 99% of that individual's time is spent fulfilling the responsibilities of his or her corporate position. Can the reader envision the Contractor's anger if we were to propose the disallowance of 90.48% of the salary of the head of Medicare A because we found that the individual had met with the corporate president on several occasions? We believe the correctness of the specific allocation approach to be self evident and continue to propose the entire $275,803 adjustment.

reduced our proposed adjustment by $5[illegible] reflecting the reallocation of Finance and Government Administration costs. The Contractor, however, still does not concur with $65,422 of the proposed adjustment which is the result of including the Champus program in the basis used to spread costs. The Contractor states Champus should not receive an allocation of the GDC start up costs because it was not part of the initial planning for GDC and because $1,285,977 of $1,481,153 in start up costs had been incurred before the Champus contract was awarded and services were performed.

We take exception with the Contractor on both issues. The Contractor's attachment #4, Management Summary states the purposes of the Government Data Center were to reduce claims expense and position the Government Business Division to expand and acquire new business. The same memo includes the Champus program as a target market. It is clear the Data Center was established with growth in mind. The Contractor also states that most of the start up costs were incurred prior to any services being provided for the Champus contract. This is true, however a closer look at attachment #4 pages 7 and 8 show that the entire $1,395,538 of computer start up costs and $126,215 in distribution service costs were incurred prior to providing services for Medicare B. A similar late start situation exists for PSP yet both of these programs received start up cost allocations. The allocation of costs to the Champus program is equitable. We continue to propose the entire adjustment of $91,086.

cc24514 Executive Benefits - The Contractor disagreed with the proposed adjustment stating productive hours were used as the allocation basis for this cost center and that our proposed adjustment is incorrect because no chargeback was posted to the Medicare accounts in January of 1989.

The Contractor is only partially correct. We agree there was no chargeback to the Medicare recipient codes in January of 1989. However, the offsetting charge back account was also not used. The use of both chargeback accounts did not begin until February of 1989. In addition, we agree that the cost center used a productive allocation base, however, the base used was budgeted rather than actual productive hours. The allocation percentages for this cost center did not change for a period of seventeen months between January of 1988 and June of 1989. Our proposed adjustment adjusts these budgeted amounts to actual. We continue to support the proposed $6,112 adjustment.

cc23100 Public Affairs - The Contractor has proposed removing lobbying time and travel and entertainment costs from this cost center and allocating the balance of the costs on the equal markets approach. The Contractor proposes an adjustment of $3,648 as opposed to our proposed adjustment of $91,070.

First we would like to note that the Contractor used incorrect allocation percentages for its equal markets approach alternative calculated on attachment #8 page 7 of 7. The equal market percentage changed from 5.55 to 4.76 on January 1, 1988 the weighted average for Fiscal 1988 should be 4.96 and the percentage for 1989 should be 4.76. The result would be a minimum adjustment of $10,630 even under the Contractor's approach. Secondly it is apparent that segments of this cost center's responsibilities other than that of lobbying are non-Medicare related. Even in the Contractor's rebuttal it speaks of publishing a news letter to several thousand "opinion leaders". Even though this news letter may have been of an informative or technical nature, it's purpose was obviously the dissemination of information designed to bring favorable attention to the Contractor for the purpose of enhancing its company image - clearly unallowable for Medicare purposes. The Contractor also speaks of filing contracts and rates with its state regulatory agency - obviously private lines related. In summary, there may be some Medicare related activities in this cost center but the Contractor has still not provided documentation to support the occurrence of these activities or their volume. Consequently the Contractor has not supported the reasonableness of the equal market approach and the cost center remains unallowable. We continue to propose the original $91,070 adjustment.

supporting an allocation from this cost center. The cost center remains unallowable.

cc24307 On-Site Parking and Security - The Contractor admits the allocation from this cost center to the Medicare programs was a clerical error but states the amount so allocated should be accepted because this cost center supported cost centers which allocate to Medicare.

The cost center remains unallowable. The Contractor has not documented a reasonable allocation method.

cc24536 Executive Loaned - The Contractor disagrees with the proposed adjustments stating the Pan American Games participation was a community service.

The Pan American Games is an amateur sports event. It is not an allowable community service activity such as a charity drive or a blood drive. Rather, it is an unallowable public relations cost designed to bring favorable attention to the company. The cost center remains unallowable.

cc31495 Internal Audit Market Services - The Contractor disagrees with the proposed adjustment stating this cost center supported internal audit and that the allocations from this cost center were comparable to those of Internal Audit.

The Contractor has never presented a cost center profile or a CAID with supporting documentation. The allocation percentage from the Internal Audit Cost Center is small. It is quite possible this cost center never supported a Medicare related project. Without documentation the cost center remains unallowable.

cc31530 New Products - The Contractor disagrees with the proposed adjustment stating the cost center was involved with the implementation of the Medicare A Arkansas system.

The Contractor states this cost center was involved with the Medicare A system implementation yet $1,017 of the proposed $1,674 disallowance was charged to Part B. Without documentation the cost center remains unallowable.

cc24531 Staffing - The Contractor states the increased allocations to the Medicare programs from this cost center are the result of increased consulting costs from an employee attitude survey and a corporate salary survey. It also believes the budgeted productive hours percentages used by this cost center were a reasonable allocation basis. It does, however, admit that certain recipient codes, due to decentralization, dropped off the productive hour reports. To compensate for this fact it proposes to offset fee for service income against the cost center expenses prior to allocation. The result is a proposed $12,591 adjustment as opposed to our proposed adjustment of $146,535.

We do not concur with the Contractor's statement that the allocation percentages utilized by this cost center were reasonable. Even if we use the average of the productive hour percentages presented by the Contractor for Fiscal 1989, the rates for Part A and B would be 7.21% and 14.63%, respectively resulting in a total adjustment of $21,102 as opposed to the Contractor's proposed $12,591. A further look at the statistics, however, points to the fact that even these percentages with the offset of fee for service income are not reflective of the overall effect of the decentralization process. If the sum of the total productive hours for the months of January, May and September for 1988 and 1989 are compared (See attachment 19) it can be seen that the productive hour base of 1,328,586 dropped to 850,899, representing a 36% drop in the statistic used to generate the allocation percentages. During this same period the Part A allocation percentage allocated to the Medicare programs if [illegible] to be allocated remained constant. Furthermore, during these same months Medicare productive hours dropped from an average of 78,174 per month to 63,345 hours per month, a decrease of almost 19% per month. **In summary**, a 19% decrease in productive hours is resulting in a 27% increase in the **dollars** allocated to the Medicare programs - hardly an equitable allocation methodology. An estimate of the total effect of the decentralization process could be developed by placing 1989 hours over the 1988 base which represents total corporate hours before decentralization. The result would produce a $75,018 proposed adjustment due solely to the change in the allocation statistic.

Secondly, although the above calculation would produce a proposed adjustment of $75,018 we don't believe this to be sufficient given the nature of the cost center and the decentralization process that was going on during the period. Between Fiscal 1988 and 1989 this cost center's expenditures increased from $506,833 to $977,728, an increase of $470,895 or 92.9%. The Contractor stated the major new activities causing this increase were an attitude survey and a salary survey. At the end of 1989 the Contractor through its decentralization process and acquisitions consisted of the parent company and approximately sixty-three subsidiary corporations and partnerships. Yet during the three months used for our statistical development in the aforementioned paragraph the amount of hours charged to subsidiary administration actually decreased from 35,945 hours in 1988 to 34,428 hours in 1989. In addition as previously noted the overall allocation base decreased by 36% suggesting the cost center was serving a lesser population base. Yet in comparing the cost center's expenditures not only were consulting charges increased due to the surveys, but salaries and employee benefits increased by $91,865 representing a 26.47% increase in personnel costs. It isn't logical that personnel costs would increase over 26% while serving 36% less population. Nor is it logical to have a decease in subsidiary administration time during the period of decentralization and subsidiary increase. We believe decentralization was the direct cause of a substantial portion of this cost center's increased costs during Fiscal 1989 and the newly formed subsidiaries substantially benefited from the cost centers increased personnel and both the employee attitude and corporate salary surveys. To properly allocate costs a direct charge methodology rather than a distorted productive hours statistic should have been used by this cost center. We continue to propose our original $146,535 adjustment.

cc26140 Corporate Analysis and ISD Staff - The support provided is based on estimates and prior year percentages unadjusted to the current years actual figures. The cost center remains unallowable.

cc24100 Corporate Services Administration - With the government programs receiving no allocations from the cafeteria (see Attachment #23 page 1/2), Market Street garage, Illinois Street garage and the Monument Circle building and with the contraction of the responsibilities of the fleet vehicle services cost center, the equal markets approach has not been supported for Fiscal 1987 and 1988. Considering the government programs were no longer housed in the downtown Indianapolis area, the productive hour approach has even less credibility. The Contractor speaks of assuming the risk management function in 1989. The prior risk management cost center was allocated using the equal market approach which in 1989 would have produced Part A and Part B percentages of 4.76% not 5.84% and 11.37%. In addition this would have been for this single area. What about those with no government allocation? What is the functional distribution of the cost center responsibilities? The allocations remain unsupported and unallowable.

cc31340 Commercial Market Services - We have received additional information from the Contractor supporting this cost center's allocation methodology. Our review of the information, however, disclosed two errors 1) finance hours were allocated using a 5.55% rate as opposed to Fiscal 1989's 4.76% rate 2) all legal hours were allocated to Part A as opposed to all of the government programs. The result is a reduction of our proposed adjustment from $100,115 to $24,471. (See Attachment 24 4/7 for calculation of $24,471).

[illegible]3492 (SD) Business Services - The Contractor states this cost center used paperless claims percentages for its allocation basis, yet page 1/2 of attachment #26 does not agree to the same monthly rate used from March through December of 1988 found on page 2/2. We have also not yet been provided a cost center description to evaluate whether paperless claims counts would be an appropriate allocation basis. The cost center remains unallowable.

AUTOMOBILE COSTS

The Contractor claimed $338,942 in Fiscal Year 1987, $80,362 in Fiscal 1988 and $43,087 in Fiscal 1989 of unallowable automobile costs. These costs which relate to payments to employees as opposed to Contractor owned automobiles, as the corporate fleet was disposed of in late calendar 1986, may be described as follows;

Vehicle transition payments $278,240

Consists of the amount allocated to Medicare for a $3500 one-time payment to each employee, who had a corporate automobile, received upon liquidation of the corporate fleet. Since no miles were incurred and no services were performed, these payments are unallowable both as automobile costs and compensation.

Appendix B Section XIII states:

> ...The reasonable cost of such automobiles which may be charged to this agreement/contract shall be actual cost not to exceed the rate published in the Federal Travel Regulations....

FAR Section 31.205-6(a)(1) states:

> ...Compensation for personal services must be for work performed by the employee....

Automobile monthly allowances $178,675

Rather than pay its employees for business mileage at a set amount per business mile the Contractor pays its employees monthly automobile allowances ranging from approximately $225 per month for most employees to $515 for certain executives. Mileage logs are not kept to support either business miles or use percentages. Thus, the entire amount is being disallowed for lack of supporting documentation.

Executive tax reimbursements $5,476

High level executives ar being reimbursed for the tax amounts attributable to the personal usage of company automobiles being declared on their W-2's. These costs are unallowable in accordance with FAR 31.201-6(a) which states:

> ...When an unallowable cost is incurred, its directly associated costs are also unallowable....

Overstatement of FACPs

	Fiscal Year ended September 30			
	1987	1988	1989	Total
Part A	$173,505	$42,335	$21,051	$236,891
Part B	165,437	38,027	22,036	225,500
Total	$338,942	$80,362	$43,087	$462,391

Recommendation

We recommend the Contractor reduce its FACPs by the above amounts.

Contractor Response

The Contractor did not concur with the proposed adjustment. It stated that 1) Vehicle transition payments, executive car allowances and executive tax reimbursements related to the amounts declared as income for the personal use of automobiles should be considered as compensation rather than automobile costs and 2) that the auditor did not understand the workings of the Automobile Standard Costing Method of reimbursement and that these costs should be allowable.

Auditor's Additional Comments

1) The Contractor states that vehicle transition payments were related to the compensation lost by all employees who had fleet vehicles when the fleet vehicle program was eliminated. It uses the example of the 1985-1986 FACP audit adjustment removing the costs related to the personal use of vehicles. By the Contractor's own admission these payments were directly related to the employees' loss of the use of the company's vehicles for personal usage.

   FAR Section 31.201-6(a) clearly states:
   ...When an unallowable cost is incurred its directly associated costs are also unallowable....

   The only people receiving payments were those who had the use of a company vehicle. There is no question that these amounts were compensation related to the loss of an item specifically disallowed by Medicare. As such, they are unallowable.

   The Contractor also states executive car allowances and executive tax reimbursements for amounts declared as income for the personal use of automobiles should be considered as part of total compensation. Again the FAR is very specific.

   FAR Section 31.205-6(m)(2) states:
   ...That portion of the cost of company furnished automobiles that relates to personal use by employees is unallowable regardless of whether the cost is reported as taxable income to the employees....

   In summary all three items; vehicle transition payments, executive car allowances and executive tax reimbursement are all directly related to the personal use of automobiles and unallowable (Note: If both this portion of the finding and the cost center allocation finding entry to cc24515 are upheld the total of the two proposed adjustments should be reduced for Fiscal 1989 by $2,594 and $2,145, for Parts A and B respectively to avoid duplication.)

2. The Contractor also disagrees with the $167,126 portion of the proposed adjustment related to employee auto allowances, calculated using the ASC reimbursement method. The Contractor is correct in its statement that we did not understand the working of the ASC system because we were told by the Contractor's personnel that business mileage records were not kept. It is also evident however, based on the Contractor's submission that an automobile driven 12,000 business miles per year through May of 1989 would result in a $780 disallowance for reimbursement above the allowable Federal Travel Regulation Rate. An automobile driven less than 12,000 miles would result in a higher rate per mile disallowed, more than $12,000 a lower rate per mile. It is the Contractor's responsibility to isolate and remove unallowable costs. Our proposed adjustment stands until such time as the Contractor submits to HCFA workpapers calculating and removing unallowable ASC amounts thereby substantiating the remaining costs.

The Contractor claimed $97,073 in the Fiscal Year ended September 30, 1987 and $129,552 and $100,659 in the Fiscal Years ended September 30, 1988 and 1989 of unallowable professional and consulting costs. These costs include accounting fees, legal fees, business consulting costs, employment fees, the Insurance Commissioners audit fees and software costs which are either related to the Contractors affiliates or its non-Medicare lines of business. The distribution of these fees is as follows;

	1987	1988	1989
Accounting fees	$ 1,188	$ 8,233	$ -
Legal fees	6,540	32,025	24,209
Business consulting	75,525	62,602	73,907
Employment fees	-	15,621	545
Insurance Commissioner fees	7,990	11,056	1,998
Software costs	5,830	15	-
	$ 97,073	$129,552	$100,659

Appendix B to the Medicare agreements Section XV states:

...The following items are unallowable:

A. All direct and indirect costs which relate to the Contractors non-Medicare business....

The inclusion of non-allocable professional and consulting costs has caused the following overstatement of the FACPs

	Fiscal Year Ended September 30			
	1987	1988	1989	Total
Part A	$ 46,613	$ 61,238	$ 51,450	$159,301
Part B	50,460	68,314	49,209	167,983
	$ 97,073	$129,552	$100,659	$327,284

Recommendation

We recommend the Contractor reduce its FACPs by the above amounts.

Contractor Response

The Contractor concurs with $211,233 of the proposed $327,284 finding. The areas of disagreement are as follows:

Legal Fees - the Contractor states that all payments to outside legal counsel were paid through account 75002, the account being disallowed. It states that it reviewed the invoices pulled for the audit and found invoices clearly unrelated to Medicare, retainer fees with no explanation of services performed and services with a relationship to Medicare. It states the small percentage allocation from the legal cost center should take care of outside legal bills. The Contractor is asking that some percentage be allowed. There is no proposed amount.

Executive Search Fees - The Contractor believes that the costs associated with the recruitment of a V.P. of Business Development are allocable and is requesting the reinstatement of $1,488.

Health Care Video - The Contractor is requesting that the $27,780 allocated to the Medicare programs be allowed as the video does not advertise products or services and was used to raise the awareness of the problems and increasing costs in the health care industry.

Demographic Study - The Contractor believes demographic studies on work force changes should be allowable and disagrees with the proposed $380 adjustment.

[illegible]

accrual should have been reversed when the other portion of the accrual was reversed. It is requesting a $2,585 reduction of the proposed disallowance.

<u>Insurance Commission Costs</u> - The Contractor disagrees with the proposed $21,044 disallowance of State Insurance Commissioner Costs. It believes these to be an allowable general business expense.

<u>Auditor's Additional Comments</u>

<u>General</u>

The Contractor begins its response by stating "A key point is that we are not dealing with items that are expressly non-allowable per FAR Regulations or Appendix B of the Medicare Contract. This adjustment only deals with the appropriateness of the Medicare allocation percentage." We would like to correct any misinterpretation of the Professional and Consulting Cost finding. All of the proposed disallowances are based on the F.A.R. They are not based on the correction of cost center allocations. Also the "unreasonable burden" referred to by the Contractor would consist of placing a * after the accounting code of a non-Medicare related item.

<u>Legal Fees</u>

All payments to outside legal counsel were <u>not</u> included in account 75002. Account 75001, Legal services retained council, allocated $7,339 to the Medicare programs during the period of audit. The amounts being proposed for disallowance were contained in the 75002 account entitled <u>Legal Services Not Charged to Government</u>. Although designed for non-government related legal charges, the account was erroneously allocated to the Medicare programs. The legal fees in this account were related to subsidiaries, acquisitions, mergers, liquidations, reorganizations, class action suits, other individual personal suits, related to the Contractor's private lines and retainer fees with no support as to the services performed. The Contractor has not supported any allowable legal fees with a relationship to Medicare. In addition we fail to see what effect the size of the allocation percentage has on the allocation of a non-allowed account. The proposed $62,774 adjustment remains unallowable.

<u>Executive Search Fees</u>

The Contractor has not presented a position as to why the V.P. of Business Development fees should be allocated to Medicare. In addition the Business Development Cost Center does not allocate to Medicare. The 1488 remains unallowable.

<u>Health Care Video</u>

Although the video itself may be factual in nature, it was obviously produced to bring favorable attention to the company and its products. The $27,780 disallowance remains.

<u>Demographic Study</u>

We fail to understand how Medicare would benefit from a demographic work force study. The $380 disallowance remains.

<u>Accrual Reversal</u>

The unallowable amount charged to the Medicare programs was the amount removed. The $2,585 disallowance remains.

<u>Insurance Commissioner</u>

Similar adjustments have been contested and finally accepted by the Contractors in Louisiana, Arkansas and Texas. We continue to support our proposed $21,044 disallowance.

RETURN ON INVESTMENT COSTS

The Contractor underestimated its return on investment Costs for the Fiscal Years ended September 30, 1987 and 1988 by $156,393 and $126,081 respectively, and overstated its Fiscal 1989 costs by $28,977. These under and overstatements were the result of the Contractor estimating its 1987 and 1989 amounts and not claiming its return on investment for Fiscal 1988.

At our request the Contractor calculated its return on investment costs in accordance with the regulations, for all three years under audit. The workpapers reviewed and accepted by us resulted in the listed variances between the amounts originally claimed and those calculated.

The use of estimated return on investment amounts and the failure to claim any return on investment for Fiscal 1988 resulted in the following over (under) statement of the FACPs.

	Fiscal Year Ended September 30			
	1987	1988	1989	Total
Part A	$ (87,292)	$ (56,738)	$18,049	$(125,981)
Part B	(69,101)	(69,343)	10,928	(127,516)
Total	$(156,393)	$(126,081)	$28,977	$(253,497)

Recommendation

We recommend the Contractor (increase) decrease its FACPs by the above amounts.

Contractor Response

The Contractor concurred with this finding.

GAINS AND LOSSES ON THE SALE OF DEPRECIABLE PROPERTY

The Contractor understated its FACPs for the Fiscal Years ended September 30, 1987, 1988 and 1989 by $(17,122), ($1.519) and $(4,784) respectively . The understatements occurred because the Contractor did not treat its gains and losses on the sale of depreciable property as an allocable expense to the Medicare program in accordance with FAR 31.205-16(a) which states:

> ...Gains and losses from the sale, retirement or other disposition....of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included....

We determined Medicare's portion of the gains and losses for each Fiscal Year based on its depreciation allocation percentages. The amount for Fiscal 1987 has been adjusted in accordance with the Contractor's previous audit report which found some Fiscal 1987 losses to be attributable to 1986.

The failure of the Contractor to allocate its gains and losses to the Medicare programs in accordance with the FAR resulted in the following over (under) statement to the FACPs.

	Fiscal Year Ended September 30			
	1987	1988	1989	Total
Part A	$ (10,429)	$ 11,242	$(1,930)	$ (1,117)
Part B	(6,694)	(12,761)	(285466)	(22,309)
Total	$(17,122)	$ (1,519)	$(4,784)	$(23,426)

Recommendation

We recommend the Contractor (increase) decrease its FACPs by the above amounts.

Contractor Response

The Contractor concurred with this finding.

DEFERRED COMPENSATION

The Contractor claimed $2,071 in the Fiscal Year ended September 30, 1987 and $64,281 and $64,699 in Fiscal 1988 and 1989, respectively, of unallowable deferred compensation expense.

Our review of the cost centers and the accounts involved revealed the Contractor had overallocated to the Medicare programs both the executive and the management deferred compensation plan costs. In addition, in Fiscal 1988 and 1989 both the expense associated with the deferred compensation amount and the expense associated with the life insurance premium payments related to the deferred amounts were allocated to Medicare.

	Fiscal Year Ended September 30		
	1987	1988	1989
Executive	$2,071	$42,455	$36,117
Management	-	6,679	11,703
Life Insurance	-	15,147	16,879
Total	$2,071	$64,281	$64,699

The overallocations and duplicate expense are unallowable in accordance with the FAR section 31.204-4 and the CASB 30.415.40(b) which state;

> ...A cost is allocable if it is assignable or chargeable to one or more cost objective on the basis of relative benefits received or other equitable relationship....
>
> ...The measurement of the amount of the cost of deferred compensation shall be the present value of the future benefits to be paid by the Contractor....

Overallocations and duplicate charges caused the following over (under) statements of the FACPs

	Fiscal Year Ended September 30			
	1987	1988	1989	Total
Part A	$(1,221)	$15,940	$20,164	$ 34,883
Part B	3,292	48,341	44,535	96,168
	$ 2,071	$64,281	$64,699	$131,051

Recommendation

We recommend the Contractor (increase) decrease its FACPs by the above amounts.

Contractor Response

The Contractor does not disagree with but questions 100% of the proposed $131,051 adjustment.

1) The Contractor questions the use of the all markets approach to reallocate the deferred compensation amounts. It states only 12% of the account in 1987 related to the two top executives who would use the equal markets approach and that the deferred compensation program increased from 74 participants in 1987 to 88 in 1989. The proposed adjustment for this area is $80,643.

2) The Contractor questions the proposed $32,026 disallowance for executive life insurance questioning the source of the allocation percentages and the development of $8,753 of the adjustment. It has requested additional information.

3) The Contractor questions the proposed $18,382 adjustment related to the executive deferred compensation program. It has requested additional information.

Auditor's Additional Comments

1) The Contractor should analyze its accounts before it responds to a finding. This portion of the finding relates to account #71409 pension expense. Because of the Contractor's lack of workpaper analysis we were forced to analyze 100% of this account for all three Fiscal years. In Fiscal 1987, for instance, the composition of this account was as follows:

Pension Expense	$1,203,403
Deferred Compensation Expense	174,048
PBGC Payment	25,832
Interest on late payment	145
Miscellaneous Adjustments	9,755
Total	$1,413,183

The deferred compensation for the two executives ($174,048 divided by $1,413,183) is approximately 12%. However, it is 12% of the total account. It is not 12% of the deferred compensation charged. The entire amount (100%) of the deferred compensation $174,048 was accrued for two executives (8 mos. x $21,756). In support of this contention is a letter from the Contractor's then actuaries, McCready and Keene, Inc., instructing the Contractor to begin accruing on January 1, 1987 $21,756 per month for the two executives. There is no question the equal markets approach is appropriate.

In Fiscal 1988 and 1989 the Contractor did accrue deferred compensation amounts for other individuals. However, $1,121,305 of the total $1,398,819 accrued or over 80% of the deferred compensation expense was related to the two previously covered and a third top level executive whose salaries were allocated using the equal markets approach. The remaining $277,514 was accrued for various other individuals. We were never able to obtain the exact detail as to how much and for whom this amount was accrued, although our requests for this information began as early as August 13, 1990. One list we were given resulted in a 4.07 and 4.09% allocation rate for Part A and B respectively. Rates lower than the equal markets approach. Another list contained many more individuals and included subsidiary participants, which could under the specific identification methodology result in even a lesser percentage. We feel we have been more than equitable in using the equal markets approach. As for the use of productive hours statistics, our discussion in other sections of this report have proved the dilution of these statistics to the point that they become useless. We continue to propose the total $80,643 adjustment.

2 and 3) Both executive life insurance and executive deferred compensation adjustments were calculated on the basis of a weighted average developed through the specific identification of the individuals involved, the amounts pertaining to them and their individual cost center allocation statistic. Once again the Contractor was allocating costs associated with the employees of both its subsidiaries and the parent company forcing us to use the specific identification methodology. We noted thirty-two employees of subsidiaries covered under this program. The proposed adjustments of $32,026 and $18,382 remain unchanged. The $8,753 reduction to which the Contractor makes reference is the life insurance expense related to the deferred compensation portion of the life insurance policy expense, net of the increase in cash surrender value, taken from a workpaper prepared by the Contractor's budget manager. We would be surprised if the Contractor does not have a copy. We also question why the Contractor did not ask us for additional supporting documentation for proposed entries between the time supporting workpapers were given them for review and the present or at least during the two and one half months given the Contractor for response. We have, however, supplied the Contractor with the additional requested information.

INTEREST COSTS

The Contractor claimed $9,036 in Fiscal 1987, $13,604 in Fiscal 1988 and $39,528 in Fiscal 1989 of unallowable costs for interest on unfunded deferred compensation programs for executives and on life insurance loans used to fund an additional deferred compensation program for managers.

These costs are unallowable in accordance with FAR 31.205-20, which states:

> ...Interest on borrowing (however represented)...and directly associated costs are unallowable....

The inclusion of nonallowable interest caused the following overstatement of the FACPs

	Fiscal Year Ended September 30			
	1987	1988	1989	Total
Part A	$4,518	$ 6,300	$17,953	$28,771
Part B	4,518	7,304	21,575	33,397
Total	$9,036	$13,604	$39,528	$62,168

Recommendation
We recommend the Contractor reduce its FACPs by the above amounts.

Contractor Response
The Contractor concurs with $18,325 of the proposed $62,168 adjustment. The areas of disagreement are $14,205 in interest expense related to life insurance loans which the Contractor states is included in the $18,325 adjustment to which it agrees. Also $29,638 in interest related to the Contractor's deferred compensation funding process. (Note the Contractor has not yet taken a position on the $29,638 stating that it has requested it's corporate finance staff to review this item.)

Auditor's Additional Comments
The Contractor has stated that it believes the deferred compensation interest in the amount of $18,325 includes the $14,205 of interest on life insurance loans that we have also proposed for disallowance. A closer look by the Contractor would disclose, executive benefits interest (account #71417) is an internally calculated amount based on the amount it is believed the company will have to pay on its deferred compensation program. It is calculated at 112.5% of the Contractor rate to estimate the effects of a 25% interest bonus if an employee stays until retirement. Interest began accruing on the program in Fiscal 1988. Interest on life insurance loans on the other hand did not even begin until Fiscal 1989. This is actual interest on loans taken out against life insurance policies. The interest along with life insurance premiums were expensed to (account #71419) Executive Life Insurance. The remaining $29,638 of disallowed interest is the result of discounting the accruals for a separate unfunded upper level deferred compensation program to present value. The interest being disallowed is the additional cost of the program due to its lack of funding. It is similar to the interest that is disallowed for the late payment of pension payments. We continue to propose the entire $62,168 for disallowance.

TAXES

The Contractor both over and (under) claimed its personal property and Indiana Gross income taxes resulting in a net $55,451 overcharge to the FACPs for the Fiscal Years ended September 30, 1987, 1988 and 1989. The over and under charges occurred because the taxes were allocated to Medicare based on budgeted amounts which were not adjusted to actual at each year end.

Over (under) charge	Fiscal Year Ended September 30		
	1987	1988	1989
Personal Property taxes	$24,239	$ -	$ -
Indiana Gross income tax	48,841	(20,653)	3,024
Total	$73,080	$(20,653)	$3,024

These costs are unallowable in accordance with FAR 31.204-4 which states:

> ...A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship....

The allocation of taxes based on budgeted amounts caused the following over (under) statement of the FACPs.

	Fiscal Year Ended September 30			
	1987	1988	1989	Total
Part A	$36,333	$ (4,944)	$(8,630)	$22,759
Part B	36,747	(15,709)	11,654	32,692
Total	$73,080	$(20,653)	$ 3,024	$55,451

Recommendation

We recommend the Contractor (increase) decrease its FACPs by the above amounts.

Contractor Response

The Contractor concurred with this finding.

ADVERTISING, DUES, ENTERTAINMENT AND CONTRIBUTIONS

The Contractor for the Fiscal Years ended September 30, 1987, 1988 and 1989 claimed $44,547 of unallowable advertising, dues, travel, entertainment and contribution costs. In addition, in Fiscal 1987 in an attempt to remove advertising costs, the Contractor overcredited the advertising accounts resulting in a negative allocation to Medicare. In Fiscal 1988 and 1989 Blue Shield Dues were inadvertently overcharged and in 1989 charged to Part A as opposed to Part B. The distribution of the over and (under) charges is as follows:

	1987	1988	1989
Advertising	$(10,320)	$6,635	$ 3,597
Contributions	1,502	4,805	24,307
Blue Shield Dues	-	12	1,821
Entertainment, travel and social club dues	4,383	4,141	3,664
	$(4,435)	$15,593	$33,389

These costs are unallowable by annual agreement as to the maximum Blue Shield dues and in accordance with Appendix B to the Medicare agreements and the FAR which state:

> Appendix B Section XV A.1.
> ...The following items are unallowable:...Costs related to the acquiring or enrolling of new subscribers, including selling, advertising and other promotional costs....
>
> Appendix B Section XV B.
> ...The following items are unallowable:...Contributions and donations....
>
> FAR Section 31.205-14
> ...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 purposes are also unallowable....
>
> FAR Section 31.205-46(d)
> ...Airfare costs in excess of the lowest customary standard, coach or equivalent airfare offered during normal business hours are unallowable....

The inclusion of non-allowable advertising, dues, travel, entertainment and contribution costs has caused the following over (under) statement of the FACPs.

	Fiscal Year Ended September 30			
	1987	1988	1989	Total
Part A	$(2,910)	$ 7,851	$23,847	$28,788
Part B	(1,525)	7,742	9,542	15,759
Total	$(4,435)	$15,593	$33,389	$44,547

Recommendation

We recommend the Contractor (increase) decrease its FACPs by the above amounts.

Contractor Response

The Contractor concurs with $42,752 of the proposed $44,547 adjustment. It has, however also noted a possible $4,265 duplication of adjustments if cc23100 is disallowed in total in the cost center allocation finding.

The area of disagreement is as follows:

> **Blue Shield Dues** - the Contractor states that $1,795 of the proposed adjustment was the result of a duplicate payment which was corrected in Fiscal 1990. Since 1989 and 1990 would wash out the Contractor is proposing the adjustment be dropped.

Auditor's Additional Comments

> Blue Shield Dues - Fiscal 1989 was over the maximum amount allowable per agreement with HCFA. An adjustment should be made to the Fiscal 1990 FACP.

SEVERANCE PAY

Our review of the Contractor's consulting expense account for the Fiscal Year ended September 30, 1987 revealed a $275,297 severance payment to a former executive vice president, $27,530 of which was allocated to the Medicare programs. The entire amount is being proposed for disallowance as excessive because we did not receive a copy of an employee contract requested from the Contractor. Without this agreement we couldn't determine reasonableness.

> The FAR Section 31.205-6(g)(2)(ii) states
> ...Actual normal severance payments shall be allocated to all work performed...if the amount of the accrual is reasonable in light of payments actually made for normal services over a representative past period....

The allocation of the excessive severance payment to the Medicare program caused the following overstatement of the FACPs:

	Fiscal Year Ended September 30 1987
Part A	$13,765
Part B	13,765
	$27,530

Recommendation

Based on the nature of the above severance payment, we recommend the adjudication of a reasonable amount with HCFA.

Contractor Response

The Contractor states there is no justification for disallowing the entire severance pay amount that was allocated to the Medicare Programs. It states the payment was in accordance with an employer-employee agreement.

Additional Auditor's Comments

Although our proposed adjustment removed the entire severance payment allocation our recommendation recommended the adjudication with HCFA of a reasonable amount. In addition, it should be noted the Contractor has not yet provided a copy of the employee-employer agreement.

OUT OF PERIOD COSTS

Our review of the Contractor's manual entries to reconcile its cost accounting system to the FACPs revealed that $145,285 of consulting costs and wages relating to the Fiscal Year ended September 30, 1988 had been recorded as Fiscal 1989 costs.

According to the FAR these costs are unallowable in 1989 and accordingly are being reclassified to Fiscal 1988. The FAR Section 31.201-2 states:

> ...The factors to be considered in whether a cost is allowable include the following:...(3)....generally accepted accounting principles.

Generally accepted accounting principles require the inclusion of the expense in the period the service was provided.

The inclusion of Fiscal 1988 expenses in Fiscal 1989 costs caused the following over (under) statement of the FACPs.

	Fiscal Year Ended September 30		
	1988	1989	Total
Part A	$ (4,000)	$ 4,000	$ -
Part B	(141,285)	141,285	-
	$(145,285)	$145,285	$ -

Recommendation

We recommend the Contractor (increase) decrease its FACPs by the above amounts.

Contractor Response

The Contractor originally agreed with only $34,771 of the proposed $145,285 reclassification. On discussion with the Contractor's Assistant Governmental Controller, the Contractor now also concurs with the additional $9,994 referred to in point #3 of the Contractor's response for a total agreed to amount of $44,765. The Contractor continues to disagree with the reclassification of $100,521 stating its manual reclassification from Fiscal 1988 to 1989 was proper.

Additional Auditor's Comments

All invoices supporting the $100,521 are for services provided prior to September 30, 1988 and all invoices are dated between June 30, 1988 and September 30, 1988. There is no question the $100,521 is a Fiscal 1988 expense. We continue to propose the entire $145,285 reclassification.

INDIANA GROSS INCOME TAX

The Contractor claimed IGIT based on its estimated Fiscal Year gross receipts. We disallowed the differences between claimed and allowable taxes as discussed in the taxes finding earlier in this report.

Because the findings in this report will reduce the Fiscal Year gross receipts the IGIT should be reduced accordingly. We did not compute the adjustments because it should be based on the amount of sustained disallowances.

Recommendation

In order to properly calculate the IGIT adjustment related to this reports disallowances, we recommend that HCFA calculate the disallowed IGIT based on the final report determinations.

Contractor Response

The Contractor did not respond to this finding.

OTHER MATTERS

DHHS and HCFA requested that we specifically address several issues during our audit. These issues are discussed below.

SIGNIFICANT INCREASES/(DECREASES) IN COSTS BETWEEN YEARS

To assess significant variations in costs we compared costs reported by operations on the Contractor's FACPs.

Fiscal Year 1986 Compared to Fiscal Year 1987 (Part A)

Operation	% Increase (Decrease)	Description
Medicare Secondary Payer	40.0	Reportedly due to HCFA funding additional MSP responsibilities, particularly in the area of MSP Disability Funding. Also, enhancement of prepayment MSP function.
Medical Review and Utilization Review	(19.2)	This decrease was reportedly because of a reduction in system support needed after the implementation of the Arkansas System. In addition, less effort needed after transfer of Home Health Agency free standing claims to the regional intermediary.

Fiscal Year 1986 Compared to Fiscal Year 1987 (Part B)

Operation	% Increase (Decrease)	Description
Beneficiary/Physician Inquiry	51.8	Reportedly due to the Contractor doing a better job of segregating costs between lines 1 through 3. Also, excess costs over the cap were reportedly taken from line 3 in 1986 but only from line 1 in 1988.
Medicare Secondary Payer	123.4	Reportedly, this increase was due to new MSP responsibilities and special projects (new funding for MSP disability.)
Physician Fee Freeze	50.7	Reportedly due to 1986 special projects for COBRA - Participating Physician - which was shifted from the special projects line to the Physician Fee Freeze line.
Productivity Investments	93.7	Reportedly based on HCFA project initiatives. Nine different projects were funded in 1987.
Other	(63.9)	Reportedly due to removal of COBRA Participating Physician funds from other to Physician Fee Freeze.

Fiscal Year 1987 Compared to Fiscal Year 1988 (Part A)

Operation	% Increase (Decrease)	Description
Reconsideration and Hearings	87.4	Reportedly due to increased emphasis by HCFA in 1988 in this area.
Provider Desk Reviews Provider Field Audits	31.9 (17.3)	Reportedly based on HCFA instructions and internal reviews, a significant number of Medicare providers were moved from audit to no audit status in 1988.
Provider Settlements	34.1	Reportedly due to specific HCFA direction to settle all SNF and hospital cost reports that were reopened or held open as a result of the 1987 change in Malpractice Regulations.

Fiscal Year 1987 Compared to Fiscal Year 1988 (Part B)

Operation	% Increase (Decrease)	Description
Reviews and Hearings	101.7	This increase is reportedly due to an increasing workload and an effort to improve the area due to poor CPEP scores.
Productivity Investments	172.0	Reportedly due to a $1,000,000 in funding for the VIP's system implementation.
Other	100.0	Reportedly the result of a HCFA Carrier incentive system to reward for increases in participating physicians.

Fiscal Year 1988 Compared to Fiscal Year 1989 (Part A)

Operation	% Increase (Decrease)	Description
Provider Field Audits	18.3	Reportedly due to a HCFA initiative to increase the quality of audits. HCFA required a 10-15% increase in the average hours per audit.
Productivity Investments	(56.6)	Reportedly, one time projects. However Notice of Utilization project funded as a productivity investment in Fiscal 1988 was budgeted in the bills payment section in Fiscal 1989.

Fiscal Year 1988 Compared to Fiscal Year 1989 (Part B)

Operation	% Increase (Decrease)	Description
Claims Payment	13.4	Reportedly, the result of processing 13% more claims in 1989 plus the budgeting of EMC costs on line 1 as opposed to productivity investments.
Beneficiary/Physician Inquiry	27.1	Reportedly due to an increased allocation of data processing costs to this area plus a 68% increase in written inquiries which are more expensive to answer. Overall there was a 12.4% increase in the area workload.
Professional Relations	100.0	Reportedly, the increase is due to the establishment of a new line item on the FACP for professional relations costs which were reported in other areas in the past.
Medical Review and Utilization Review	36.2	Increase is reportedly due to an expanded claim review function and the fact the carrier was selected for the Medical Review Flexible Carrier Project for which it received an additional 600,000 in funding.
Productivity Investments	(71.2)	Reportedly, the decrease is due to the deletion of the $1,000,000 in funds provided for system implementation if Fiscal 1988.

SIGNIFICANT ELECTRONIC DATA PROCESSING COSTS

During Fiscal 1988, the Contractor implemented a new Part B bills processing system called the Metropolitan Medicare System. VIPs, Inc. assisted the Contractor in implementing the system. Total costs incurred were $1,454,173. HCFA approved $1,000,000 for the system change. The additional $454,173 was not reported on the Part B FACP for Fiscal 1988.

INTERIM EXPENDITURE REPORTS

We reviewed the methodologies used to prepare the Cumulative Interim Expenditure reports October 1, 1989 through May 31, 1990. Our limited reviews did not disclose any material inaccuracies or weaknesses. Our review was limited to the testing of whether amounts were properly transcribed. We did not evaluate nor do we attest to the amounts claimed for reimbursement.

COSTS INCURRED BUT NOT CLAIMED

The Contractor's Fiscal 1986 Medicare agreements contained unit cost target rates for each bill (Part A) and claim (Part B) processed for certain FACP operations, as follows:

- Part A: Bills Payment and Reconsideration and Hearings
  $2 in Fiscal 1986 $1.90 in 1987   and $1.81 in 1988

- Part B: Claims Payment, Reviews and Hearings and Beneficiary/Physician Inquiry
  $1.78 in Fiscal 1986 $1.65 in 1987   and $1.54 in 1988

The Contractor was entitled to reimbursement for actual allowable costs incurred in Fiscal 1986 and 1987. Reimbursement exceeding the target rates in these years however would reduce the Fiscal 1988 target rates. Rather than have its 1988 rates reduced by overages, the Contractor chose not to report all of its costs for Fiscal 1986 and 1987. In addition, in Fiscal 1988 the Contractor once again exceeded its targeted rates resulting in additional unclaimed costs. The following summarizes costs incurred but not claimed for the period under audit.

	1987	1988
Part A	$ -	$ 612
Part B	310,400	541,288
Part B System Implementation	-	417,293
Total	$310,400	$959,193

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INDEPENDENT AUDITOR'S REPORT

We have audited the Final Administrative Cost Proposals of Associated Insurance Companies, Inc. for the period October 1, 1986 through September 30, 1989. These Final Administrative Cost Proposals are the responsibility of the Company's management. Our responsibility is to express an opinion on these Final Administrative Cost Proposals based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, 1988 revision, published by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Final Administrative Cost Proposals are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts in the Final Administrative Cost Proposals. An audit also includes assessing the overall presentations of the Final Administrative Cost Proposals. We believe that our audit provides a reasonable basis for our opinion.

The accompanying Final Administrative Cost Proposals, as adjusted for the $3,355,560 of unallowable and unallocable costs and the Indiana Gross Income Tax thereon as described in the Findings and Recommendations section of this report present fairly, in all material respects, the cost of administration allowable and applicable to Parts A and B of the Health Insurance for the Aged and Disabled Program for the period October 1, 1986 through September 30, 1989, in accordance with the reimbursement principles of FAR Part 31, as interpreted and modified by the Medicare agreements.

Our examination was made for the purpose of forming an opinion on the Final Administrative Cost Proposals taken as a whole. The information on pages 1-29 is presented for the purposes of background and analysis and is not a required part of the Final Administrative Cost Proposals. Such information has been subjected to the auditing procedures applied in our examination of the Final Administrative Cost Proposals and, in our opinion, is fairly stated in all material respects in relation to the Final Administrative Cost Proposals taken as a whole.

This report is intended solely for the use described above and should not be used for any other purpose.

Sheffield Dallmann & Haley, Ltd.

Sheffield Dallmann & Haley, Ltd.

January 27, 1993

SHEFFIELD DALLMANN & HALL, LTD.
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REPORT ON REVIEW OF INTERNAL CONTROL

We have audited the Final Administrative Cost Proposals of Associated Insurance Companies, Inc. for the period October 1, 1986 to September 30, 1989, and have issued our report thereon dated January 27, 1993.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Final Administrative Cost Proposals are free of material misstatement.

In planning and performing our audit of the Final Administrative Cost Proposals of the Contractor for the period October 1, 1986 through September 30, 1989, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the Final Administrative Cost Proposals and not to provide assurance on the internal control structure.

The management of the Contractor is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories.

- o Procedures to assure accurate, current, and complete disclosures of the financial results of the Medicare program in accordance with Federal reporting requirements;
- o Records that adequately identify the application of funds:
- o Effective control over and accountability for all funds, property, and other assets;
- o Comparison of actual with budgeted amounts for each period:
- o Procedures for determining the allowability and allocability of costs in accordance with the FAR Part 31, and Appendix B of the Medicare agreements;
- o Accounting records that are supported by source documentation.

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the Final Administrative Cost Proposals.

> All reportable conditions are described in the Findings and Recommendations section of this report on pages 3 to 29.

A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the Final Administrative Cost Proposals being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we noted the following reportable conditions that we believe to be material weaknesses.

> The $3,355,560 cumulative effect of the reportable conditions as described in the Findings and Recommendations section of this report on pages 3 to 29 are the result of the following material weaknesses:

1) The Contractor does not properly document and review its cost center descriptions and allocation methodologies on a current and continuing basis, nor does it apparently require the cost center heads to retain documentation for their cost center allocations.

2) The Contractor does not properly directly charge costs related to its private lines, resulting in over allocations to the Medicare programs.

3) The FACPs are being prepared in a haphazard manner as cost center allocations are not adjusted from budget to actual at year end and estimated amounts as opposed to calculated amounts are being reported for such major items as complimentary insurance and return on investment.

4) There are apparently no documented procedures in effect to review the allocations to the Medicare programs on a monthly or even an annual basis. As a result natural accounts and cost centers allocated in error are not being removed from the Medicare lines of business.

<u>Recommendation</u>

The improper documentation and review of cost center allocation methodologies and the improper allocation of direct charges, the fact that the FACPs are being prepared using estimates, and the lack of proper effective review procedures, appears to indicate that the entire cost system is not functioning at an acceptable level for HHS reporting purposes. The current proposed adjustments of $3,355,560 represent 5% of the total costs claimed. The fact that these proposed adjustments are not the result of a single item or of a system aberration may be further supported by the Fiscal 1985, 1986 HHS audit which proposed $2,530,409 of disallowances representing in excess of 6% of the total claimed costs.

Based on the above, we recommend that the Contractor immediately undertake a study of its entire cost allocation system. Systems and procedures must be documented from the point of input through the final allocation review and FACP preparation process. Responsibilities must be assigned and implementation assured by the training of staff from cost center heads through general accounting and cost accounting personnel.

Contractor Response

The Contractor admits some errors in the preparation of the 1987-1989 FACPs especially in the areas of staff and support overhead. It points to the fact that without the proposed complementary insurance adjustment, total adjustments would only be three percent. It denies any major internal control weakness stating its controls are quite reasonable as they relate to direct costs and improving with respect to overhead costs.

Auditor's Additional Comments

A material weakness is not based on a specific percentage of disallowance but rather on specific internal control structure elements that do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material may occur and not be detected by employees in the normal course of performing their assigned functions. In our opinion the points listed in 1-4 on the preceding page constitute material weaknesses. In addition we don't believe that the Contractor's piecemeal remedial action will solve the problem. The entire system must be documented and responsibilities assigned.

This report is intended for the information of the Department of Health and Human Services and the Contractor's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Sheffield Dallmann & Haley Ltd.

Sheffield Dallmann & Haley, Ltd.

January 27, 1993

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REPORT ON COMPLIANCE

We have audited the final Administrative Cost Proposals of Associated Insurance Companies, Inc. for the period October 1, 1986 through September 30, 1989 and have issued our report thereon dated January 27, 1993.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Final Administrative Cost Proposals are free of material misstatement.

Compliance with laws and regulations applicable to the Contractor is the responsibility of the Contractor's management. As part of obtaining reasonable assurance about whether the Final Administrative Cost Proposals are free of material misstatement, we performed tests of the Contractor's compliance with certain provisions of laws and regulations. However, our objective was not to provide an opinion on overall compliance with such provisions.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in statutes, and regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the Final Administrative Cost Proposals. The results of our tests of compliance disclosed the following material instance of noncompliance.

UNALLOWABLE COSTS CHARGED TO THE MEDICARE PROGRAM

As described in the Findings and Recommendations section of this report, the Contractor charged Medicare $3,355,560 of unallowable and unallocable costs. These costs are unallowable in accordance with the FAR Part 31, and the terms and conditions of the Medicare agreements.

We considered this material instance of noncompliance in forming our opinion on whether the Contractor's Final Administrative Cost Proposals are presented fairly, in all material respects, in conformity with generally accepted principles, and this report does not affect our report dated January 27, 1993 on those Final Administrative Cost Proposals.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, the Contractor complied, in all material respects, with the provisions referred to in the third paragraph of this report, and with respect to items not tested, nothing came to our attention that caused us to believe that the Contractor had not complied, in all material respects, with those provisions.

This report is intended for the information of the Department of Health and Human Services and the Contractor's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Sheffield Dallmann & Haley, Ltd.

Sheffield Dallmann & Haley, Ltd.

January 27, 1993

Exhibit I

Associated Insurance Companies, Inc.
Final Administrative Cost Proposal (Part A)
October 1, 1986, Through September 30, 1987

Operation	Administrative Costs Claimed	(1) Increase (Decrease) Recommended Adjustments
Bills Payment	$2,761,347	$(223,047)
Reconsiderations and Hearings	146,103	
Medicare Secondary Payer	647,922	
Medical Review and Utilization Review	833,831	
Provider Desk Reviews	582,778	
Provider Field Audits	1,170,796	
Provider Settlements	308,281	
Provider Reimbursement	434,500	
Productivity Investments	190,614	
Other	48,573	
Costs Not Associated With an Operation		(81,210)
Total	$7,124,745	$(304,257)

(1) See Findings and Recommendations sections of this report. The opinion of Sheffield Dallmann & Haley, Ltd. on this FACP appears on page 30.

Exhibit 2

Associated Insurance Companies, Inc.
Final Administrative Cost Proposal (Part B)
October 1, 1986, Through September 30, 1987

Operation	Administrative Costs Claimed	(1) Increase (Decrease) Recommended Adjustments
Claims Payment	$7,504,772	$(311,192)
Reviews and Hearings	688,503	
Beneficiary/Physician Inquiry	1,719,039	
Medical Review and Utilization Review	1,723,458	
Medicare Secondary Payer	621,867	
Physician Fee Freeze	275,313	
Productivity Investments	576,182	
Other	175,064	
Costs Not Associated With an Operation		(103,844)
Total	$13,284,198	$(415,036)

(1) See Findings and Recommendations sections of this report. The opinion of Sheffield Dallmann & Haley, Ltd. on this FACP appears on page 30.

Associated Insurance Companies, Inc.
Final Administrative Cost Proposal (Part A)
October 1, 1987, Through September 30, 1988

Operation	Administrative Costs Claimed	(1) Increase (Decrease) Recommended Adjustments
Bills Payment	$2,806,396	$(194,004)
Reconsideration and Hearings	273,853	
Medicare Secondary Payer	633,905	
Medical Review and Utilization Review	728,814	
Provider Desk Reviews	768,708	
Provider Field Audits	967,874	
Provider Settlements	413,504	
Provider Reimbursement	445,410	
Productivity Investments	233,193	
Other	70,663	
Costs Not Associated With an Operation		(177,539)
Total	$7,342,320	$(371,543)

(1) See Findings and Recommendations sections of this report. The opinion of Sheffield Dallmann & Haley, Ltd. on this FACP appears on page 30.

Associated Insurance Companies, Inc.
Final Administrative Cost Proposal (Part B)
October 1, 1987, Through September 30, 1988

Operation	Administrative Costs Claimed	(1) Increase (Decrease) Recommended Adjustments
Claims Payment	$7,638,318	$(505,320)
Reviews and Hearings	1,388,945	
Beneficiary/Physician Inquiry	1,647,921	
Medical Review and Utilization Review	1,893,340	
Medicare Secondary Payer	719,425	
Physician Fee Freeze	364,999	
Productivity Investments	1,567,327	
Other	79,300	
Costs Not Associated With an Operation		(74,057)
Total	$15,299,575	$(579,377)

(1) See Findings and Recommendations sections of this report. The opinion of Sheffield Dallmann & Haley, Ltd. on this FACP appears on page 30.

Associated Insurance Companies, Inc.
Final Administrative Cost Proposal (Part A)
October 1, 1988, Through September 30, 1989

Operation	Administrative Costs Claimed	(1) Increase (Decrease) Recommended Adjustments
Bills Payment	$3,017,112	$(189,740)
Reconsideration and Hearings	262,262	
Medicare Secondary Payer	606,774	
Medical Review and Utilization Review	676,693	
Provider Desk Reviews	711,484	
Provider Field Audits	1,144,829	
Provider Settlements	528,564	
Provider Reimbursement	502,093	
Productivity Investments	101,180	
Other	-	
Costs Not Associated With an Operation		(469,648)
Total	$7,550,991	$(659,388)

(1) See Findings and Recommendations sections of this report. The opinion of Sheffield Dallmann & Haley, Ltd. on this FACP appears on page 30.

Exhibit 6

Associated Insurance Companies, Inc.
Final Administrative Cost Proposal (Part B)
October 1, 1988, Through September 30, 1989

Operation	Administrative Costs Claimed	(1) Increase (Decrease) Recommended Adjustments
Claims Payment	$8,661,812	$ (440,531)
Reviews and Hearings	1,417,422	
Beneficiary/Physician Inquiry	2,095,286	
Professional Relations	400,440	
Medical Review and Utilization Review	2,578,727	
Medicare Secondary Payer	703,667	
Physician Fee Freeze	406,909	
Productivity Investments	452,087	
Other	78,400	
Costs Not Associated With an Operation		(585,428)
Total	$16,794,750	$(1,025,959)

(1) See Findings and Recommendations sections of this report. The opinion of Sheffield Dallmann & Haley, Ltd. on this FACP appears on page 30.

APPENDIX

CONTRACTOR RESPONSES TO FINDINGS AND RECOMMENDATIONS

May 7, 1993

Mr. Roger A. Sheffield
Sheffield, Dallman & Haley, Ltd.
Certified Public Accountants
1837 Wehrli Road
Naperville, IL 60565

RE: Draft Audit Report
FY 1987 - 1989

Dear Mr. Sheffield:

In response to your letter dated March 9, 1993, we have prepared the attached responses to the adjustments included in your draft audit report for fiscal years 1987-1989. I am sure you received a copy of the letter from Mr. Polasek of the Office of Inspector General who extended the due date for our response. As a part of our response, we have also commented on our system of internal controls which is questioned in the draft report.

Our response clarifies many of the issues raised in your adjustments. We appreciate your review and consideration of this response prior to the finalization of the audit report. We would be happy to meet with you here in Indianapolis or at your office to discuss any of your questions or to provide additional documentation.

If you have additional questions, please contact Peg Rusterholz or myself.

Sincerely,

Dennis W. Brinker

Dennis W. Brinker, CPA
Chief Financial Officer and
Vice President

DWB/pml

Enclosure

Response to the Draft Report of Audit Findings

On the following pages, we have commented on each proposed adjustment in your draft report, and have provided supporting documentation where appropriate. In those cases where we agree with or accept the adjustment, our agreement is noted in the specific response.

We have also made comments on your report section titled "Costs Incurred But Not Claimed". In this section, we have identified certain unreimbursed costs over and above those caused by the fixed cost agreement in FY 1987 and 1988. These unreimbursed costs should be used in full to offset adjustments made on this audit as we reach a final settlement.

The draft audit report also includes a Report on Review of Internal Control which questions the internal controls we had in place during the audit period. While we agree that errors were made and that additional review could have been done, we do not agree that those errors identify any major internal control weakness. The audit report refers to the cumulative total adjustment of $3,918,946 as evidence of weak internal controls. The largest individual adjustment for Complementary Insurance Credits represents $1,863,834 of the total adjustment effect. This adjustment identifies perhaps a difference of opinion as to the methodology for computing the crossover rate but not a weakness in internal controls. Backing just this one item reduces the total cumulative effective to $2,055,112, 3.05% of total claims costs.

As detailed in our individual responses, we disagree with several of the proposed adjustments and have provided supporting documentation which should significantly reduce the final effect of the audit. Several of these adjustments with which we disagree again represent a difference of opinion as to allowability and not an internal control weakness.

In response to the list of specific weaknesses, we make the following comments:

1. **We have consistently reviewed cost center allocation bases, and appropriate direct charges for our direct Medicare cost centers which make up the bulk of total costs claimed on the FACP's. Our controls are reasonable within the Medicare area as supported by the limited number of adjustments in this area. We agree that improvements were needed in the review and accumulation of data for the corporate overhead cost centers, especially in the area of natural accounts that by title are of questionable allowability. On the other hand, direct charging of costs to lines of business can be taken to the extreme. In overhead areas that allocate small percentages of cost to Medicare, it is unreasonably burdensome to be required to direct charge every consulting, contract labor, accounting, and other invoice to determine the precise allocation to Medicare. We as a corporation attempt to develop logical allocation bases for staff and support cost centers and then use these bases to allocate all expenses reflected in the cost center. This approach may understate**

g. MR/UR Prepayment Cost - Our disagreement here is in many ways similar to that explained for MSP. Prepayment medical review is a part of the process of paying a Medicare claim but it is a Medicare specific function and not a material part of the complementary insurance claim transfer. We do not pay complementary insurance claims, we merely transfer claim records to the complementary insurer. As with MSP, we believe that the Intermediary Manual gives no indication that MR/UR should be a part of the credit calculation. Such a change cannot be implemented after seven years when the manual section has not changed at all.

One suggested technical correction should be mentioned here. We suggest that the FY 1988 prepayment percentage be used to calculate FY 1987 prepayment medical review costs instead of an average of FY 1988 and 1989. As FY 1988 is closer to FY 1987, it seems using FY 1988 only for the FY 1987 estimate would be more accurate.

h. Travel - Travel is a specific Medicare expense that is unrelated to the complementary insurance transfer and of no direct benefit to the insurer.

i. Other Expenses for Cost Center 39000, 39210 and Overhead Cost Centers - For Cost Centers 39000 and 39210, Government and Medicare A administrative cost centers and for overhead cost centers, we included personal service costs and several other expenses as general claims processing overhead that should be a part of the complementary credit calculation. On the other hand, we excluded telephone, travel and postage that were deemed unrelated to the process of supplying electronic claim records to complementary insurers.

j. Cost Center 39216 (FY 1988 and 1989) - As Cost Center 39215 changed its focus in FY 1988 and personnel moved from overhead Cost Center 31220, Cost Center 39216 was established to be the Medicare A systems unit. This unit was responsible for analysis and implementation of mandated HCFA system or other administrative changes. The Medicare activities performed here do not benefit the complementary insurer.

k. Claim Workload Counts - Without specific comments in the audit workpapers, the auditor failed to include the claim deletes and adjustments we had identified in our credit calculation. We continue to express our opinion that costs are incurred for the deletes and adjustments. Workload counts for these items must be added to claims processed to calculate an appropriate complementary insurance credit rate.

Medicare allocations in certain cases and overstate them in others, but in total, is a reasonable accounting procedure. We do agree that major consulting projects should be directly charged and that we have at times failed to recognize those projects.

2. In response to another comment, we acknowledge that our Return on Investment process was inadequate in FY 1987 and 1988. We knew we were under-reporting this item, but knew that with the fixed price agreement we would not get reimbursement anyway. By FY 1989 our Return on Investment development process had improved. Regarding complementary insurance credit rates, we believe our controls and calculations were reasonable. This process just began in late FY 1986, and even to this day, HCFA has not clearly defined the costing methodology. We did supply documentation supporting the crossover rates we used that was based on actual costs.

In summary, we admit some errors in the preparation of the 1987-1989 FACP's, especially in the area of staff and support overhead. We are working to better capture supporting data for cost allocations and to more successfully review certain accounts for allowability. In total, however, our controls are quite reasonable as they relate to direct Medicare costs and improving with respect to overhead costs.

Complementary Insurance Credits

After review of the draft audit adjustment and supporting workpapers, we remain convinced that the original complementary insurance rates used in preparation of the FY 1987-1989 FACP's are reasonably computed and in accordance with Section 1601 of the Medicare Intermediary Manual. This manual section has been in place since the original effective date of May 16, 1986 without any modification or clarification by HCFA. Absent any more specific instructions, we developed an approach that in our opinion satisfied the manual requirements, and have applied that approach consistently for almost seven years. The auditors have applied a different interpretation of the manual instruction that goes beyond the specific wording in the manual.

Our complementary insurance process is a partially integrated claims process as defined in Section 1601 B. Providers and beneficiaries submit one claim form to Medicare only. We process the Medicare claim and transmit paid claim information to the complementary insurer (primarily the private side of our operation). We do not process the complementary insurance payment or control in any way the other insurer's review and payment process.

Additionally, we point out that in almost all cases, complementary insurance pays only the deductible and/or coinsurance amounts which the Medicare program deducts from its final payment. Per Mr. Crickmore, Indiana laws prohibit subrogation or coordination of benefits for individual supplementary insurance policies which means that whether Medicare pays all, a portion, or none of a Medicare claim does not relieve the complementary insurer of its liability to pay its covered benefits. This fact argues against the need to include Medicare Secondary Payor or Medical Review expenses in the calculation of the crossover credit. We will comment further on MSP and Medical Review as we respond to the specific audit changes to the rate calculation.

In general, we believe the audit premise that any cost that benefits Medicare must also benefit the complementary insurer is an assumption that is not supported by the practicalities of how the process works or by the manual instructions. The rate should be computed by identifying and sharing those claims processing costs that apply to both the Medicare claim and the supplementary claim.

In the following paragraphs, we will respond to the specific changes made by the auditors in their recalculation of the complementary credit rate.

1. Part A

   a. Cost Centers 31220 and 31340 - Since we prepare a tape transfer of claim records for the complementary insurer, neither the batching of claims nor the preparation of

Medicare forms would be necessary if not for the Medicare processing requirements and reporting. These activities do not enhance the complementary insurance process and deserve to be excluded for computing the credit. Batch numbers especially provide no essential element of information to the complementary insurer.

b. Cost Center 39215 and 39223 - Of course we agree that provider training improves the quality of submitted Medicare claims, but neither provider training nor the implementation of required system changes affect the basic information provided to the complementary insurer (beneficiary name, eligibility number, amount of deductible and coinsurance). The expense incurred in this cost center is basically Medicare specific and adds no identifiable benefit to the complementary insurer.

c. Materials and Supplies - We reiterate the position taken on our original rate calculation. Perhaps some small amount of materials and supplies is related to general claims processing. For the most part, these items are necessary to control claims and keep records for the Medicare program. These types of costs do not affect the electronic record provided to the complementary insurer.

d. Return on Investment - The fact that Return on Investment is added to expenses incurred for FACP reporting does not make Return on Investment an expense. It is instead a return provided to Medicare contractors for using investable funds to purchase assets to administer the Medicare program. Clearly Return on Investment is not an expense that should be included in the credit calculation.

e. Cost Centers 24534 and 31121 - Photocopy cost through this staff and support overhead cost centers again relate to the claim batching and control process and should not be included. The training cost center is not considered related to the complementary claim process.

f. Medicare Secondary Payor - As noted in our general response to this finding, the complementary insurer knows the beneficiaries who have its coverage and is just interested in receiving basic claims information from us for its insureds. The insurer needs the beneficiary name, health insurance number, and the amount of deductible and/or coinsurance that are its responsibility. As we attempted to explain during discussions on this subject during the audit, the MSP analysis done for Medicare claims is basically unrelated to the development of the complementary insurance record and not of value to the insurer. Claims for which Medicare is a secondary payor will never go to a complementary insurer since the beneficiary in question is still working and has primary coverage, not complementary coverage. MSP costs should be removed from the total to compute an accurate credit rate per claim.

b. Siegal and Gale payments in Cost Center 30000 related to the Health Systems video - Further review has indicated that the video in question here is entitled "Health Care in America: In Search of Solutions". This video goes through several of the problems which have caused the huge increases in health care costs and at the end suggests some solutions to the identified problems which, if implemented, would at least slow down the increase in costs. The film does not advertise in any way products or services directly marketed by the Associated Group or any of its subsidiaries. It was used to raise the awareness of the serious problems affecting our health care system and was shown to a wide variety of audiences. We believe that the costs of producing this video are indirectly applicable to Medicare and that the 9.52% of the total cost allocated to Medicare is reasonable. The specific invoices related to this project that were denied in the draft report are detailed as follows:

Workpaper	Total Cost	Medicare A	Medicare B
4008 C 3/6	$ 1,620.00	$ 77.09	$ 77.09
4008 C 3/6	5,200.00	247.46	247.46
4008 C 3/6	1,461.86	69.57	69.57
4008 C 3/6	30,000.00	1,427.65	1,427.65
4008 C 4/6	14,800.00	704.66	704.66
4008 C 4/6	96,000.00	4,570.76	4,570.76
4008 C 5/6	1,516.18	68.38	68.38
4008 C 5/6	48,000.00	2,164.80	2,164.80
4008 C 5/6	48,000.00	2,280.00	2,280.00
4008 C 5/6	48,000.00	2,280.00	2,280.00
Total	$294,598.04	$13,890.37	$13,890.37

Attached are invoice copies for some of the Siegel and Gale services for your review.

c. Brian Boswort payments in Cost Center 23300 (Workpaper 4008 C 4/6) - Per the audit workpaper, the two invoices involved here related to the review of demographic work force changes for the Associated Group and the analysis of the report prepared from that review. We believe that this was an overall review for which an allocated share to Medicare is reasonable. Total amounts involved for these two invoices are $190.40 each for Medicare A and B.

3. Business Consulting - Account 75806 (Outside Labor)

Audit review of payments allocated to Medicare through this account produced denials of significant amounts considered unrelated to Medicare. Almost all of the denials were in Systems and other staff areas which allocate small percentages of their cost to Medicare.

2. <u>Part B</u>

a. Cost Centers 31340, 24534, and 31120 - Travel and Other Expenses - Comments made in our Part A response apply here also.

b. Return on Investment - The rationale expressed in our Part A response is applicable to Part B.

c. MSP and MR/UR - The details of our position were expressed in our Part A response is applicable to Part B.

d. Cost Center 31350 - Similar to our comments regarding the Part A adjustments, micrographics is necessary for Medicare claim processing to maintain an audit trail, to answer inquiries, etc. Our position is that this activity is not necessary for the complementary insurer who works from a tape transfer of applicable data.

e. Cost Center 39225 - We continue to state our original position that the whole cost center should be excluded. Control of claim files and microfilming are again specific Medicare required activities. Control numbers and microfilming provide no material benefit to the complementary insurer who works from a tape transfer of applicable information.

f. Cost Centers 39224 and 39223 - Similar to cost centers explained in Medicare A, personnel in these cost centers were involved with the design, testing and implementation of required system changes. While this effort is certainly a part of processing claims, the expense involved should be held out in calculating the complementary credit.

g. Claim Workload Counts - Without comment in the audit workpapers, the auditor failed to include the adjustments and reopenings workload that we added to claims processed in calculating the credit rate. Our position is that cost related to the adjustments and reopenings is included in claims processing costs, and therefore the workload should also be added in to compute an accurate rate.

h. Materials and Supplies (FY 1988 and 1989) - The position stated in our Part A response also applies here.

i. Anacomp and Micrographics - The cost of microfilming are again Medicare related expenses that have no material benefit to the complementary insurer. A decision not to incur these costs would not materially affect the data transmitted to the complementary insurer.

services clearly unrelated to Medicare services, services with a relationship to Medicare, and retainer fees with no clear listing of services performed.

Most of these outside legal fees were paid through Cost Centers 22000 and 22100 in the Legal Division which charges only a small percentage of its total cost to Medicare. The allocation percentage itself should take care of eliminating the outside legal bills. If this is not sufficient, then some percentage of the outside legal fees should be allowed for Medicare reporting.

1. Other Consulting - Account 75803

Audit review of payments allocated to Medicare through this account produced denials of items considered unrelated to Medicare. We have reviewed the denied invoices and noted that most are in cost centers that allocate small percentages of their cost to Medicare.

After additional review, we disagree with several of the denied payments as follows:

a Korn Ferry search fees for Vice President of Business Development in Cost Center 30000 - We believe that the position being recruited is reasonably charged to Medicare as an allocated cost and that search firm fees should therefore be treated as allowable. Invoices related to this search are identified as follows:

Workpaper	Total Cost	Medicare A	Medicare B
4007 A 4/4	$ 2,262.54	$125.79	$125.79
4007 A 4/4	2,513.15	139.48	139.73
4007 B 1/2	1,507.25	83.65	83.80
4007 B 1/2	3,917.93	186.53	186.53
4007 B 1/2	4,382.70	$208.36	$208.36
Total	$14,583.57	$743.81	$744.21

j. SCA Expense - The auditor added back SCA costs to claims processing cost at the Line 1 percentage. We certainly contracted with SCA in the hope of increasing productivity and reducing costs. We believe that this was a productivity investment activity and that including it in the calculation of the complementary credit rate distorts the result. This type of one-time project should be excluded.

In summary, the complementary credit rates used in these fiscal years are actual cost based and reasonable in relation to the instructions in the manuals. We have updated the rates as appropriate based on our understanding of the manual provisions. The inclusion of MSP and MR/UR expenses in the calculation is a change without specific support in the instructions.

Cost Center Allocations

In this group of adjustments, Staff and Support overhead allocations to Medicare were either totally eliminated or modified after audit review. We have performed a detailed review of each cost center for which an adjustment was made. Our individual responses are detailed in the following analysis.

1. Cost Center 10002 - Board of Directors

   In Calendar Years 1986 and 1987, this cost center was allocated to the five operating markets only. Starting January, 1988 we added an allocation to investment management. In this case, we accept the audit adjustments.

2. Cost Center 24515 - Executive Compensation

   This cost center was set up in December, 1988 to include personal service costs for a group of corporate executives who made up the President's Council. Attached is a memo from Mr. Crickmore, Vice President of Medicare Operations during this period, who was and is a member of the President's Council. In the memo, Mr. Crickmore provides a general understanding of the organization structure and activities of this group.

   The original Medicare allocation for this cost center used the equal to markets approach used for administrative and executive areas which produced a total 11.30% allocation to Medicare. As the memo from Mr. Crickmore indicates, the individuals in this cost center acted as a group and the group's actions affected all corporate markets including Medicare. The 11.30% allocated to Medicare is reasonable as applied during 1989.

   In addition to our previous comments, we have reviewed in detail the auditor's methodology for allocating the expenses in Cost Center 24515. Based on that review, we have the following specific comments:

   a. For Mr. Rosenberg's personal service cost we have used the CAID allocation in place of Cost Center 39000 during this period. The September, 1988 CAID Document which is the latest CAID available before Mr. Rosenberg moved to Cost Center 24515 is attached as support. This CAID charges 25% of expenses to the Consumer Division instead of the 50% used in the audit calculation. When the size of the operations and the effort involved, the smaller share to Consumer Division is quite reasonable.

   b. During our review, we noted a chargeback credit to this cost center of $43,540. Further investigation indicated that this credit related to directly charging subsidiaries such as Key Benefit Administrators and Health Maintenance of Indiana for their share of

December, 1988 expenses in this cost center. We believe this credit which only was made in December, 1988 must be worked into the percentages you developed to reallocate this cost center. Including the credit as shown on the attached recalculation in effect excludes these subsidiary salaries from inappropriately affecting the calculation of the total Medicare allocation percentage.

c. For Mr. Knight's personal service cost, we have adjusted the allocation percentage to remove 20% for his oversight of the advertising function. The 20% adjustment is consistent with the adjustment basis proposed in the draft report for cost center 23000 to which we have agreed.

3. Cost Center 23000 - Public Relations

We agree that this cost center did oversee the advertising function in addition to several other activities. We accept this adjustment.

4. Government Data Center

We agree with that portion of the audit adjustment related to the identified mathematical error. We were not aware of this error until we attempted to answer an audit question.

The reallocation part of the total adjustment relates primarily to the exclusion of GDC services provided to CHAMPUS from the basis used to spread GDC costs incurred in the initial phase of its operation. We intentionally excluded the CHAMPUS direct costs from the allocation basis since a CHAMPUS contract was not part of the initial planning for the GDC. In support of this planning, attached is the narrative portion of the original Government Operations Computer Processing recommendation. We also note that we were not awarded the CHAMPUS contract until after most of the initial GDC costs we are allocating were already incurred. Of the $1,481,153 in GDC costs being allocated through this approach, $1,285,977 was incurred before GDC performed any specific services for the CHAMPUS contract. Expense summaries reflecting this are attached. This information also supports the exclusion of CHAMPUS costs from the allocation basis.

For the allocation, we also excluded Finance and Government Administration costs from the basis since they were not separate programs, just overhead areas related almost entirely to our Medicare operations. If these small items are to be included in the allocation basis, then the resultant indirect costs allocations should be added back to Medicare A and B instead of being disallowed.

In summary, we agree with the correction of the mathematical error, but do believe that the recalculation of the GDC allocation basis was inappropriate and should be reversed.

5. Cost Center 30001 - EVP Pool

During our review of proposed adjustments to the FY 1986 FACP audit we noted that the inappropriate allocation to Medicare had been reversed in November and December of 1986. We informed the auditor of this correction which led to the FY 1987 audit adjustment to reinstate the credit. We agree with this adjustment.

6. Cost Center 24514 - Executive Benefits

The allocation basis used for this cost center originally is productive hours. In our opinion, productive hours is the most reasonable basis available. In reviewing the chargeback debit allocation basis developed at audit, we noted no chargebacks in the Medicare Recipient Codes in January, 1989. This problem explains much of the variance that caused the audit adjustment.

In our opinion, the audit adjustment to the allocation basis for Cost Center 24514 should be eliminated.

7. Cost Center 24200 - Fleet Vehicle Services

Review of the allocation methodology for this cost center indicates a reasonable effort to accurately identify allocations to all user areas. The basis used in retrospect may have slightly overallocated to Medicare in the early months of FY 1987.

We accept this adjustment.

8. Cost Center 23100 - Public Affairs

The audit finding denies the entire Medicare allocation from this cost center based on the premise that the cost center is related only to the company's private lines of business. We have reviewed and attached copies of cost center profiles for 1986, 1987 and 1988. For further information, I have also had extensive conversations with Stan Huseland, then Manager of Cost Center 23100.

From speaking with Mr. Huseland, I have learned that at least half of the cost center's activities were corporate news media relations, the kind of function found in any significant company to centralize and specialize the handling of its media relations. The reference to "opinion leaders" on the 1988 profile has a general and a specific meaning. In Public Relations, one communicates to the public not only using mass communications to the "man on the street", but also disproportionately to those community leaders who influence events - leaders in business, education, government, religion and non-profit organizations, as examples. During the time period in question, the Public Affairs Unit published a newsletter to several thousand such "opinion leaders" to explain recent developments in managed care, competition vs. regulation as cost containment concepts, etc.

According to Mr. Huseland, the single most time-consuming and expense-consuming function of the cost center was the routine relationship with our regulatory agency, the State Insurance Department. Most of this activity involved the filing of contracts and rates, explaining these as necessary, or at times arranging for more specialized expertise to do so.

At the federal government level, the cost center's activity was mostly responding to constituent inquires from members of Congress, usually related to Medicare inquiries. Responding to Congressional inquiries is a required contractual activity considered extremely important by HCFA even to the extent of measuring the timeliness of our responses. Considerable effort is expended in this process.

The Legislative process at the State level took a relatively small amount of time. In the case of the Indiana Legislature, the cost center was responsible for doing what lobbying was considered necessary and appropriate to our business. For purposes of lobbying registration, Mr. Huseland has pointed out that the related filings reflect a time allocation of 5% of salary during the 1987 and 1989 Legislative sessions with 2% for 1988. Copies of these forms are attached. (NOTE: At the federal level, the efforts of this cost center were not considered lobbying and at no time was a federal filing done.)

The allocations actually received by Medicare A and B for the three years in question were based on a split between six markets. Specific entertainment accounts were excepted before the allocations were made, as indicated on the cost center profiles and as proven by limited testing.

It is openly stated that there was a lobbying function in the cost center. Due to the fact that such activities were an extremely small part of the whole and because they can be reasonably identified, we feel that it is appropriate to develop a new allocation basis rather than to disallow the entire cost center. We propose the following as a fair and equitable method:

- Remove 5% of the total personal service expense in the cost center. (In 1988, remove 2%.)
- Remove all of the entertainment.
- Remove all of the travel, as a conservative step, due to the unknown percentage which was dedicated to the limited lobbying effort.
- Apply the original allocation percentages to the adjusted numbers.

Our calculations are attached.

With the exception of the specific items listed above, we feel that this cost center contains allowable Medicare expense. Certainly, we are all aware that a Medicare contractor is required to be a health insuring organization. It is clear that the activities performed in this cost center are routine for any insuring entity of consequence.

The attached allocation methodology does produce a reasonable and justifiable allocation to Medicare. The audit adjustment should be modified to use this approach.

9. Cost Center 23001 - Winter Olympics Sponsorship
This cost center did make a small allocation to Medicare during Calendar Year 1988. After further review of the kinds of expenses being included in this cost center, we agree with the adjustment with one exception.

We noted a December 1988 entry of $30,450 as a BCBSA year end accrual. This entry was reversed in Cost Center 23001 in May, 1989 when the cost center no longer allocated to Medicare. Since the entry was reversed in the same Fiscal Year and Medicare received no credit for the reversal, we believe that the total audit adjustment should be reduced by the effect of this credit using the December, 1988 percentage allocation to Medicare which is $914.00.

10. Cost Center 26300 - Cash Management

During part of FY 1988 and 1989, an error in keying the CAID document resulted in the special allocation from Cost Center 26300 for Account 75804, Commercial Banking Service, to be directed to Medicare B (Recipient Code 050121) instead of Medicaid (Recipient Code 050122). The amount relating to this error is $23,171.

The remaining amount of the auditor's proposed adjustment is the $1,570 which was allocated to Medicare from October through December, 1986. The allocation basis at that time was a special allocation of Accounts 79001 and 75803 (Bank Service Fees Invest. and Other Consultants, respectively). These two accounts did not get allocated to Medicare; they were backed out before the percentage was applied. Excluding the special allocation of these accounts to "Investments", each of the five standard markets received 3% of the remaining expenses. The division within the Government Market resulted in 1% each being allocated to Medicare A and Medicare B.

The functions of the cost center were several, including the management of in-house cash, evaluation of long-term investments of insurance company, pension funds and the Medicaid program. The responsibilities also included reporting on investment activities and maintaining banking relations. In addition to the benefit received indirectly through staff and support areas, Medicare also received direct benefits from the activities of this cost center. Manager Bob Wiese, who has been the company's banking liaison for years, was consistently called on to assist with and/or resolve issues on the reconciliation of the Medicare A and Medicare B bank accounts. Mr. Wiese was our "management" contact with the bank. Additionally, with the cost center's work with the company's pension plan, Medicare received a direct benefit from those significant efforts. Whether or not pension required funding at the time, the program itself was still in place and necessitated oversight and management.

Clearly, Medicare deserved a share of the expense from this cost center. It would also seem that the allocation in some amount should have properly been ongoing rather than stopping at January, 1987. In conclusion, it is our opinion that the 1% amounts of allocation in question should be allowed and while no detailed supporting documentation has been located, the percentages are reasonable.

A 1% allocation to Medicare A and Medicare B from this cost center (after excluding directly charged expense accounts) would produce allocations not originally charged to Medicare in FY 1988 and FY 1989.

We acknowledge the error in charging a share of the Commercial Banking Fees to Medicare, but are of the opinion that the allocations identified above should eliminate the $1,570 FY 1987 adjustment and partially offset the Banking Fees error.

11. <u>Cost Center 24306 and 24307 - On-Site Parking and Security</u>

Both cost centers involved here allocated cost to Medicare in only one month, February, 1988 which obviously is a clerical error.

On the other hand, it is also obvious that these cost centers do provide allocable services to Medicare. Medicare Operations itself was no longer located in the Service Center, but many staff and support cost centers that allocate to Medicare were located there and utilized parking and security services.

The February, 1988 allocations to Medicare represent only 1.36% of full year Parking Facility costs and 1.18% of Security costs. Additionally, no allocations to Medicare were made in FY 1987 or FY 1989. We realize that an accurate allocation basis has not been developed, but some allocation each year is clearly appropriate. A 1% allocation to Medicare each year would be a conservative estimate, but at least the amount allocated during FY 1988 should be accepted.

12. <u>Cost Center 23005 - FEDPAC/INPAC Administration</u>

This cost center allocated to Medicare during Calendar Year 1989 in error. We agree with the proposed adjustment.

13. <u>Cost Center 26120 - Group Controller Subsidiaries</u>

We agree that this cost center should not have allocated cost to Medicare and accept this adjustment.

Our review of this adjustment did indicate that we noticed the inappropriate Medicare allocation from this cost center in August of 1987. We made an entry to remove the allocation through July, 1987 but failed to stop ongoing allocations to Medicare until January, 1988.

14. <u>Cost Center 24536 - Executive Loaned</u>

The Associated Group was one of many companies in Indianapolis that loaned employees to the Pan Am Games organizing committee as a community service. We believe that FAR Section 31.205-1(e)(3) supports the allowability of this expense as a community service. On that basis, it is also reasonable to allocate a portion of that expense to Medicare using headcount/productive hours as the allocation basis.

Based on this information, the audit adjustment to Cost Center 24536 should be reversed.

15. <u>Cost Center 31480 - Consumer Division (ISD) and Cost Center 31490 - National Division (ISD)</u>

The inadvertent single month allocations from these cost centers to Medicare were incorrect. We agree with the audit adjustment.

16. <u>Cost Center 31495 - Internal Audit Market Services</u>

This cost center is a short-lived attempt to segregate internal audit ISD support into a separate cost center. We have discussed the function with Jim Teer who per Payroll records was assigned to the cost center during its few months of existence. Mr. Teer is currently an EDP auditor in Internal Audit. He indicated that the cost center performed ISD services for Internal Audit and that manual time sheets were maintained by the staff. We have not been able to locate the time sheets but the percentage allocated to Medicare is comparable to the percentage used in the Internal Audit cost center. Based upon this information, the allocation to Medicare from the cost center should be allowed.

17. <u>Cost Center 31530 - New Products</u>

Cost Center 31530 was an ISD cost center responsible for the development and implementation of new products required by individual markets. According to cost center Manager, Bill O'Neill, areas being served at the time were Medicare, Associates Life, Actuary, and HMI. The attached memo from Mr. O'Neill gives a brief description of the area's function.

The allocation to Medicare relates to the Arkansas implementation in Medicare Part A. Though the Arkansas System was in place before the start of FY 1987, follow-up and wrap-up of the project continued on through December, 1987. The attached Recipient Code page for 1987 demonstrates that total expenses in the cost center dropped considerably as the year progressed. Personnel who worked full-time on the Arkansas implementation were moved to Cost Center 31440, Government Market. By the end of 1987, the projects were fully completed and remaining personnel were transferred to other areas.

Based on this information, we believe this cost center clearly provided services to Medicare and that the relatively minor dollars being allocated are reasonable.

18. Cost Center 35000 - Corporate Development

The minor amounts allocated to Medicare in 1987 from this cost center are inappropriate. We accept this adjustment.

19. Cost Center 24531 - Staffing

The increased allocation to Medicare in FY 1989 is primarily the result of an increase in expenses. The major new activities causing this increase are an employee attitude survey and a corporate salary survey. Both of these projects did benefit Medicare Operations.

Regarding the allocation basis used in FY 1989, attached are Cost Center Profiles for both 1988 and 1989 which indicate that productive hours is the allocation basis. It appears from a recalculation of the percentages used that budgeted productive hours were used in CY 1989. We have accumulated actual productive hours from selected months of FY 1988. These productive hours schedules are attached for your review and reasonably support the actual allocation basis used for FY 1989 and actually support larger allocations in FY 1988. We did note that with the decentralization in CY 1989, certain recipient codes dropped off the productive hour reports. We agree that the Fee for Service credits received by this cost center from these newly formed subsidiaries should have been used to reduce Medicare's allocation. The attached schedule presents our proposed recalculation.

20. Cost Center 26140 - Corporate Analysis

We have found and attached both a budgeted 1986 Cost Center Profile and CAID calculation support for Cost Center 26140. Personnel in this cost center performed financial analysis and support for ISD and other staff and support cost centers. As the Cost Allocation Basis schedule indicates, we attempted to estimate the average Medicare allocation for all the staff and support cost centers as the basis for 26140. This approach seems reasonable and produces an allocation substantially less than "Equal to Markets".

In summary, this narrative explanation and the attached schedule do support the Medicare allocation from Cost Center 26140.

23. <u>Cost Center 24100 - Corporate Services Administration</u>

During the Fiscal Years 1987 through 1989, this cost center was responsible for the direction and control of the following areas: Cafeteria, Market Street Garage, Illinois Street Garage, Security, (including Monument Circle Building Security and Medicare Security), Health Promotion Services and Fleet Vehicle Services. In FY 1989 (and at the very end of FY 1988), the cost center also acquired the function of risk management, incurring the major part of the company's insurance costs.

During 1987, this cost center was allocated equally between six markets, with Medicare A and B each getting one-third of one-sixth, or 5.55% each. As of January, 1988, the allocation basis uses a 2% direct allocation to Illinois Street Garage and 5% to MCB Security, a total of 7% which leaves the remaining 93% to be allocated evenly between five markets. NOTE: A question might arise as to why the Illinois Street Garage and Monument Circle Building Security (investment) recipients received such a small allocation from Cost Code 24100 in 1988. Looking further into the matter, it can be seen that the recipients each had only one direct cost center, 24350 and 24360, respectively. Additionally, neither of the cost centers had any personal services costs through September, 1988, consequently would not have benefitted even indirectly from many of the cost centers over which 24100 was responsible. This results in 18.6% per market, with Medicare A and B each getting one-third of that, or 6.2% each. No specific support or justification has been located, but it is assumed that the basis was due to the wide variety of areas supervised which benefit the entire company to some degree. Cost centers in this group that did not directly serve Medicare on a daily basis did perform limited services and did serve other staff and support areas that support Medicare.

For FY 1989, documentation has been located and is attached which shows the exact allocations used as of January, 1989 with 5.84% for Medicare A and 11.37% for Medicare B. While the audit letter recognizes the increase in allocation percentages, it has failed to notice the apparent reason for the increase. By FY 1989, Cost Center 24100 had assumed most of the risk management function for the corporation and consequently incurred the major portion of expense related to corporate insurance policies. The allocation basis used was productive hours with no markets being excluded. While the allocation percentages were effectively used beginning with January, 1989, it is important to notice that by September of 1988, the cost center was already incurring substantial insurance expense for the corporation. Therefore, it is reasonable to assume that these new higher percentage calculations would have been in place not later than September, 1988.

Based on this information, we believe that the Medicare allocation from Cost Center 24100 is supported.

24. Cost Center 31430 - Commercial Market Services

Through December, 1988, Cost Center 31450 was known as Financial/Actuarial. This cost center had the responsibility for activities associated with consulting and the development and maintenance of EDP systems and programs for Finance and Actuary. This cost center allocated an appropriate portion of its expenses to Medicare.

At January, 1989, the functions of this cost center were merged with ISD Cost Center 31430, Commercial Market Services. In name only, Cost Center 31450 went away. Cost Center 31430 was still known as Commercial Market Services, but in addition to its previous duties, it absorbed and continued to perform the activities of the old Cost Center 31450 with a valid allocation to Medicare.

Attached is a letter from ISD analyst Kathy Pitts along with the existing support for the allocation percentages received by Medicare. Also enclosed is a page from the Cost Systems Reports to verify the dollars, and Organization Charts from ISD showing the reorganization which resulted in the absorption of Cost Center 31450. Note that the budgeted allocation calculation for Cost Center 31430 compares reasonably with actual amounts charged.

25. Cost Center 31481 - ISD and SDE

This cost center was part of the "systems" side of paperless claims. "Source Data Entry" was the original terminology for what has subsequently come to be known as EMC (Electronic Media Claims). According to Senior Programmer Analyst Karen Steilberger, the people in this cost center were part of the Application Development Maintenance group. They maintained SDE systems. The basic functions of the systems were claims collection, editing and distribution.

The original documentation supporting the allocations to Medicare from this cost center have not been located. However, we have obtained and attached the SDE claim count information for 1988. Random calculations of the percentages of Medicare A and B claim counts to total easily support the percentages actually used for expense allocations.

Automobile Costs

The draft audit report makes adjustments to several types of employee automobile related expenses incurred in the three fiscal years under audit. We have reviewed and will respond to each adjustment item individually.

1. Vehicle Transition Payments

   In late 1986, the existing fleet vehicle program was eliminated. All employees who had fleet vehicles returned those cars to the company. As part of this process, the corporation chose to make bonus payments to many of the employees who lost their fleet vehicle. For the most part, these payments were reclassified to the Bonuses and Awards Account 71002.

   These payments should, in our opinion, be treated as compensation rather than automobile costs and should be allowed for Medicare reporting. The employees involved perceived the cars as to some extent additional compensation and the corporation chose to recognize this perception and make the bonus payments. The huge automobile FACP adjustment for FY 1985 and 1986 also demonstrates that our fleet vehicle program was extremely liberal and thus did provide additional compensation.

   In effect, the bonus payments were one form of compensation replacing another. The total compensation package covers all of the functions performed by an employee in the completion of the job assignment. Thus, it is reasonable to state that the transition payments did relate to services performed by the employees throughout that year. These payments are not restricted by FAR Section 31.205-6(Q)(i) and the adjustment should be reversed.

2. Automobile Monthly Payments

   The audit adjustment here covers the following issues:

   a. Executive car allowances.

   b. Payments under the Automobile Standard Costing method of reimbursement which went into effect when the fleet vehicle program was eliminated.

   c. Executive Tax Reimbursement.

   a. Regarding executive car allowances, these payments were reported in the Bonus and Awards Account in 1987 and 1988. Account 72207, Car Allowance, was used for 1989, but in November, 1989, we reclassified this account to Bonus and Awards also.

Professional and Consulting Costs

The adjustment here relates to the elimination of individual expenses as unrelated to Medicare in a variety of professional and consulting General Ledger accounts. A key point is that we are not dealing with items that are expressly non-allowable per FAR Regulations or Appendix B of the Medicare Contract. This adjustment only deals with the appropriateness of the Medicare allocation percentage. For the most part, these individual denials were in staff and support cost centers which allocate only a small percentage of their total expenses to Medicare.

In general, we believe that for staff and support overhead cost centers, the overall allocation basis appropriately charges a share of all expenses to Medicare including professional and consulting accounts. Having to directly assign to Medicare the appropriate share of every individual professional and consulting invoice seems to be an unreasonable burden. Our approach is that individual items unrelated to Medicare will be offset by other items that affect Medicare more significantly than the overall cost center allocation percentage.

We do agree, however, that major consulting projects should be directly assigned to the ultimate user and that certain items identified in this audit should have been more closely reviewed.

Though we question to some extent the audit approach used for Professional and Consulting, we have performed a detailed review by account of the individual expense denials. Our findings regarding those denials are expressed in the following paragraphs:

1. Legal Fees - Account 75002

Our review has indicated that all payments to outside legal counsel are included in this account. Review of the sample of invoices originally pulled for the audit indicated

This narrative information clearly supports the general allowability of payments made under the ASC program up to Travel Regulation limits. To look more specifically at the expense charged to Medicare, we used the more detailed recipient code information available in FY 1988 and 1989 to identify the individual cost centers which allocated Account 72209, ASC Reimbursement to Medicare. The results of that analysis are as follows:

Cost Center	A FY 1988	B FY 1988	A FY 1989	B FY 1989
32000	$ 31	$ 39	$ 0	$ 0
32500	0	0	1	3
32530	2,535	9,538	1,661	6,278
32540	1,639	3,754	838	1,773
32600	0	(3)	0	0
35000	2	10	0	0
39210	633	0	0	0
39215	6,360	0	2,287	0
39224	0	4,530	0	181
39250	172	2,148	0	0
39500	2,069	1,125	1,559	1,093
39510	24,875	13,879	5,746	4,535
39520	2,608	1,164	2,233	1,126
TOTAL	$40,924	$36,184	$14,325	$14,989

Cost Centers 39XXX represent direct Medicare areas. Cost Centers 32530 and 32540 were the support areas which did the electronic claims marketing and support. Medicare shared in the cost of this effort through allocation.

For four of the above listed cost centers, we performed a more detailed review of the ASC Reimbursement expenses for each year. Combined, these cost centers include over 75% of the total ASC expense charged to Medicare. The FY 1988 analysis is summarized as follows:

Cost Center	ASC Drivers	Base Payment	Bus. Mileage Payment	Total
32530	8	$21,591	$7,101	$28,692
32540	4	10,841	3,325	14,166
39510	11.5	31,262	8,650	39,912
39520	1	2,699	1,036	3,735

Attached are samples of the Monthly Business Mileage Worksheets for two ASC drivers for your review. Additional worksheets can be pulled off microfilm if needed. Additional cost center expense information is also available.

Based on this information, the ASC Reimbursement expenses do represent an allowable cost for Medicare; the audit adjustment must be revised.

We believe that these payments to executives must be looked at as part of the total compensation package, not as just car payments. As part of total compensation, these payments should be reviewed only in the context of the reasonableness of the allocation basis used for the individual cost centers involved. The provision of automobiles or automobile allowances is a fairly common component of executive compensation. This portion of the automobile adjustment should be reversed.

We also note a potential duplication in the FY 1989 portion of this adjustment. The executive car payments in FY 1989 are in Cost Center 24515; the allocation basis for this cost center is adjusted elsewhere in the draft report. If both adjustments stand, the duplication of effect must be removed.

b. Account 72209, ASC Reimbursement, accumulates expenses related to the Automobile Standard Costing (ASC) method of reimbursement which replaced the fleet vehicle program. It appears from the audit workpaper we received that the auditor did not understand the workings of the ASC system and that eligibility for this system required driving a substantial number of business miles. The attached memo to fleet vehicle drivers announced the elimination of the fleet vehicle program and summarized the new ASC program and its eligibility provisions.

Eligibility requirements included three days per week business use of a car and an estimate of at least 12,000 business miles per year. Page two of the procedure covers employee reimbursement policies. Employees on ASC received a flat payment per month plus a small, variable payment per business mile driven. Monthly Business Mileage Worksheets were required from every ASC driver which thoroughly detail business mileage. The variable payment started at $.065 per business mile. The rate increased to $.079 in May, 1989.

The audit workpaper only listed the flat monthly payments since only they exceeded the $200 minimum for invoice testing. All of the variable business mileage payments were also coded to Account 72209. The workpaper notes that business mileage was not documented when Monthly Business Mileage Worksheets were routinely completed and submitted. The Corporate Services Area (Cost Center 24200) monitored business mileage driven and periodically reported to upper level management on ASC drivers who were falling short of the 12,000 minimum and those who were significantly exceeding the minimum. Samples of these reports are attached. Employees who fell short of the minimum were at times dropped from the ASC program if lower mileage trends were expected to continue.

c. We disagree with the FAR reference quoted in the audit finding and argue that this cost should be considered part of the total compensation package and treated as allowable.

e. Arthur Andersen invoices accrued through Cost Center 31450 in December, 1987 and partially reversed in April, 1987 - We agree that the amount of the accrual that was not reversed is unrelated to Medicare. We noted, however, in reviewing this adjustment that the percentage allocation to Medicare was significantly higher in April, 1987 when the accrual reversals were made. We believe the entire accrual and reversal should have been eliminated each in their respective month. If this approach had been used, Part A costs would have increased by $771 instead of a $2,059 reduction. Part B costs would have increased by $1,640 instead of a $2,937 reduction.

4. Insurance Commissioner and Audit Costs - Account 76202

This finding denies in total the Medicare allocated share of the expenses incurred for the State Insurance Commissioner's audit.

In our opinion, these audit costs are allowable and can reasonably be allocated to Medicare. An Insurance Commissioner's audit is required for insurance companies. Since Medicare contractors are basically required to be insurance companies, these audit costs are administrative costs of doing business that should be shared by Medicare.

We also note that a focus of these audits is the adequacy of reserves and thus the solvency of the insurance company. It would appear that this solvency is important to the Medicare program.

A similar denial of these audit costs was made on the FY 1985 - 1986 FACP audit. Final settlement has not been made on these audits, but the HCFA Regional Office informed us that they were reversing the Insurance Commissioner audit adjustment. We believe that the adjustment should also be reversed for FY 1987 - 1989.

5. Software - Non-Government - Account 73106

We accept this adjustment. The fact that this account was established indicates an effort to segregate non-allowable items. The intent was to exclude this account from Medicare allocations.

Return on Investment Costs

We agree with the audit finding on this issue. We prepared the Return on Investment information for the auditor at his request.

Since expenses charged to Medicare in FY 1987 and FY 1988 exceeded HCFA's Notice of Budget Approval, we did not focus on developing an accurate Return on Investment calculation during those years.

Deferred Compensation

The adjustments grouped here relate to the funding and allocation of the Deferred Compensation program, Executive Life Insurance, and Executive Deferred Compensation. Our comments regarding these programs and the resulting adjustments are as follows:

1. Deferred Compensation

   a. First of all, we question the appropriateness of using an allocation basis related only to Banks and Kilborn for the Medicare allocation of deferred compensation. We were informed by Corporate Finance that Banks and Lytle together make up approximately 12% of the expense in calendar year 1987 and less in subsequent years as the number of plan participants increased from 74 in 1987 to 88 in 1989. With the large number of participants, it would seem appropriate to use the productive hour allocation basis applicable to Cost Center 24514.

   b. As noted in our response to the Interest Costs finding, we also question the calculation of the interest expense used to reduce Deferred Compensation before allocation. We have asked Corporate Finance to study this issue. We will forward any additional comments shortly.

2. Executive Life Insurance

   a. We question the need to back interest expense out of Executive Life expense before the allocation to Medicare. The loan interest appears to be a duplication of the interest included in Account 71417 and adjusted separately.

   b. Regarding the adjustment to the allocation basis, we have not been able to verify the source of the percentages used. On the surface, they appear low. We would appreciate additional information on the source of these percentages and their applicability to the allocation of Executive Life Insurance.

   c. We apparently do not have the workpaper that explains the $8,753 Deferred Compensation reduction made to the Executive Life total expense on Workpaper 3307 (b) 3/19. Please provide that information.

3. Executive Deferred Compensation

   a. As noted above for Executive Life Insurance, we need more information to review the revised allocation basis used.

   b. The "allowable amounts" used on Workpaper 3307 (b) 2/19 do not trace to Workpaper 3307. We need further information to support the FY 1988 and 1989 amounts.

In summary, we have not been able to complete a full analysis of this adjustment. We will forward any additional information from Corporate Finance and request that you supply information to support the noted items for which no workpapers were received.

Interest Costs

We have reviewed the somewhat complicated Executive Benefits and Deferred Compensation workpapers to identify the individual interest adjustments which make up the total. Based on that review, we have the following comments:

1. One interest adjustment disallows all interest expense allocated to Medicare recipient codes through Account 71417. We agree that the interest expense in this account is not allowable for Medicare.

2. On the same workpaper 3307, you eliminate Interest on life Insurance loans for FY 1989 as calculated on 3307(b) 4/19. Review of the amounts involved and the total interest expense involved leads us to the conclusion that this adjustment duplicates the recipient code adjustment noted above. This adjustment should be removed from the total.

3. The remaining interest adjustment is documented on workpaper 3213 and relates to the deferred compensation funding process. My question here is whether this is truly interest expense that is unallowable for Medicare purposes or just a calculation based on the funding methodology used. Clearly the interest on borrowing on the life insurance policies used to fund the deferred compensation program is unallowable, but we believe that was taken care of in your other interest adjustment. I have asked the corporate Finance staff to review this item. I expect their response shortly and will forward any new information to you.

Taxes

As noted, this adjustment reallocates both Personal Property Taxes and Indiana Gross Income Taxes to Medicare. We will comment on each topic separate as follows:

A. Personal Property Taxes

We accept this adjustment.

B. Indiana Gross Income Taxes

We accept these adjustments. The material error for Fiscal Year 1987 is a result of an allocation percentage problem in Cost Center 26001 where the IGIT was recorded in FY 1987.

Advertising, Dues, Entertainment, and Contributions

This draft adjustment relates to the review of expenses allocated to Medicare through a variety of accounts. In the following paragraphs, our response will deal with each account individually.

1. Advertising

We accept the adjustments in this account.

2. Contributions

We agree that the contributions identified here should not have been allocated to Medicare. Our review did identify contributions in cost centers whose allocation to Medicare is being reduced or denied by other adjustment. The amounts involved are as follows:

Cost Center	FY 1987 A	FY 1987 B	FY 1988 A	FY 1988 B	FY 1989 A	FY 1989 B
23000	$ 81	$ 81	$ 3	$ 3	$1,362	$1,362
23001	0	0	700	200	911	0
23100	346	346	1,217	1,217	69	69

If the allocation percentage adjustments stand, these adjustments should be modified or eliminated to avoid a duplicate hit.

3. Blue Shield Dues

Based on our review, the FY 1989 adjustment is primarily caused by making two $1,785 BCBSA payments in February, 1989. Apparently, we recognized this problem in December, 1989 and did not make a payment. Since December is in FY 1990 for Medicare purposes, we have a problem between fiscal years. We suggest that the FY 1989 adjustment be passed rather than having to carry this forward to an FY 1990 audit at some future date.

4. Entertainment, Travel and Social Club Dues

We accept this part of the adjustment.

Severance Pay

As noted in the Draft Report, we paid a total of $275,297 in Severance Pay to a former Executive Vice President of Finance. The payment was included in Cost Center 26000 and partially allocated to Medicare based on that cost center's established CAID allocation basis. In total, 10% of the severance pay was allocated to Medicare.

The FAR reference quoted in the draft finding relates primarily to the allocation approach to be used for severance pay, not specifically to the allowability of severance pay. We believe that by using our standard allocation methodology for the cost center, we have met that FAR section.

Allowability of the severance pay itself is governed, it appears, by FAR Section 31.205-6(g)(i). Item B in that Section indicates that severance pay is allowable if required by an Employer-Employee Agreement. I spoke with Fred Brown of our Human Resources area who was involved in the computation of the severance pay for the individual. He indicated that Mr. Toussaint did have an employment contract and that the severance payment made was a buyout of that contract computed on a present value basis.

We believe the severance payment is allowable and reasonably allocable to Medicare. There is no justification for denying the entire allocation to Medicare.

Out of Period Costs

This adjustment identifies expenses that in the auditor's opinion, were included in the FY 1989 FACP when they should have been included in FY 1988. Our comments regarding the individual items that make up the adjustment are as follows:

1. VIPS Accrual

We had accrued payments due VIPS in September, 1988 based upon information they sent us on projects in process. In December, we reviewed the status of this accrual as part of the preparation of the FY 1988 FACP. This review indicated that of the total accrual $142,000 was not a proper accrual by accounting practices and backed this amount out of the FY 1988 FACP. This adjustment made the FY 1988 FACP accurate in terms of VIPS expense.

Since this $142,000 accrual had actually been recorded on the General Ledger in September, 1988, we chose to track actual invoices received on these projects in FY 1989 and offset them against the existing accrual. We needed to manually add the $100,520 into the FY 1989 FACP since they had been offset against the September, 1988 accrual.

What this means in summary is that proper accounting required that these projects be expensed in FY 1989. Because they had originally been booked as accruals in FY 1988 (though not included on the FACP), we had to use the manual process to get the expense into FY 1989. The $100,520 is not a misclassification between years and should be taken out of your adjustment.

2. Expense Reclassification

The $34,771 reclassification included in your adjustment was a FY 1988 expense. We had thought that this correction had been entered into the system in September, 1988, but later found out it had not happened. We agree with this part of the adjustment.

3. Other Changes

We are unsure of the basis for the other smaller items included in this adjustment. If possible, could you provide additional information.