DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date MAR 2 1 2000

From Michael Mangano for June Gibbs Brown
Inspector General

Subject Audit of Administrative Costs Incurred Under Part A and Part B of the Health Insurance for the Aged and Disabled Program----Health Care Services Corporation, Chicago, Illinois (A-05-99-00070)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

This memorandum is to alert you to the issuance on Thursday, March 23, 2000, of our final report. A copy is attached.

The audit of Health Care Services Corporation (HCSC) was performed by the accounting firm of Doshi and Associates, P.C., under Task Order 98-23, Contract No. HHS-100-95-0027 and covered the period October 1, 1994 through September 30, 1998. Although a termination voucher had not been submitted by HCSC at the time of the audit field work, the auditors reviewed HCSC's summary of termination costs as part of their audit.

The total amount audited was $404,712,647 ($146,193,882 for Part A and $258,518,765 for Part B), including $14,308,313 in transition and termination costs. Based on the audit report, we are recommending financial adjustments totaling $9,921,720 (Part A $3,518,197/ Part B $6,403,523). The questioned items and a set aside item are as follows:

- retention bonuses totaling $7,905,171 that were part of an employee retention plan previously rejected by the Health Care Financing Administration (HCFA) as unreasonable and unnecessary; bonuses consisted of a 50 percent increase in salary paid through the transition period and most of the employees were absorbed into HCSC's private business operations or accepted positions with the new Medicare contractor;

- employee placement services costs of $374,629 that were included in the retention plan rejected by HCFA;

- severance pay of $509,912 which exceeded compensation levels specified in a HCFA approved plan;

- net book value of fixed assets that were overstated by $9,099;

- consulting fees of $92,102 for work on the rejected retention plan that are being set aside for HCFA's review and evaluation; and

- miscellaneous costs, totaling $1,030,807, applicable to:

  --Year 2000 (Y2K) project costs of $738,759 incurred after the notice of termination;

  --post-retirement benefits of $122,759 not funded in accordance with applicable regulations;

  --executive salary increases of $119,366 considered unreasonable;

  --travel costs of $31,189 that exceeded Federal per diem rates or were not supported;

  --professional consulting costs of $15,921 that were not supported; and

  --return on investment costs of $2,813 that were overstated.

The HCSC did not concur with the findings related to retention bonuses, placement services costs, and severance pay, but did not dispute the finding on the overstatement of fixed assets.

With regard to the findings related to miscellaneous costs detailed above, HCSC concurred with the findings on post-retirement benefits, professional consulting costs, and return on investment costs. The HCSC did not agree with the findings on Y2K project costs, executive salary increases, and travel costs. The full text of HCSC's comments is attached to the report.

For further information, contact:

Paul P. Swanson
Regional Inspector General
for Audit Services
Region V
(312) 353-2621

Attachment

Report on the Audit of Administrative Costs Incurred Under Part A and Part B of the Health Insurance For the Aged and Disabled Program

Health Care Services Corporation
Chicago, Illinois

For the Fiscal Years Ended September 30, 1998, 1997, 1996 and 1995
And the Termination Claim

DOSHI & ASSOCIATES, P.C.
ACCOUNTANTS AND MANAGEMENT CONSULTANTS
KANSAS CITY, MISSOURI

SUMMARY

HealthCare Services Corporation (HCSC) received, reviewed, audited and paid Medicare Parts A & B claims under agreements with the Health Care Financing Administration (HCFA). The HCSC is entitled to reimbursement for its allowable administrative costs incurred. For the period October 1, 1994 through September 30, 1998, the HCSC claimed administrative costs, as follows:

Fiscal Year	Part A	Part B	Total
1995(IL)	$ 20,643,194	$ 38,808,237	$ 59,451,431
1995(MI)	15,304,259	35,991,201	51,295,460
1996	36,503,511	64,189,639	100,693,150
1997	33,981,843	61,932,452	95,914,295
1998	38,425,183	55,259,223	93,684,406
	$144,857,990	$256,180,752	$401,038,742
Termination Voucher	1,335,892	2,338,013	3,673,905
Total	$146,193,882	$258,518,765	$404,712,647

Of the $404,712,647 in administrative costs claimed, we are recommending financial adjustments of $ 3,518,197 (Part A) and $6,403,523 (Part B). These amounts are detailed in the Exhibits and the Findings and Recommendations section of the report.

We found that the following Medicare costs were overstated:

FACP Costs-$1,030,807

- The HCSC continued to charge Medicare for Y2K project costs after receiving notice of termination. No agreement was obtained from HCFA to continue the charges and we question whether Medicare received any further benefit. Therefore, the $738,759 charged after receiving notice of termination is questioned.

- Other Post Retirement Benefits were overstated by $122,759 because those costs were not funded in accordance with Federal Regulations.

- Salary increases for selected executives were overstated by $119,366 because the increases exceeded average increases for comparable positions, as measured by the Department of Labor Employment Costs Index (ECI).

- Travel costs claimed of $31,189 exceeded the per diem rates as established in the Federal Travel Regulations, or the amount claimed was not supported.

- The HCSC did not provide support for $15,921 in professional and consulting services costs.

- The HCSC inadvertently excluded Accrued Interest and Other Investment Income in its calculation of the 1997 return on investment rate (ROI). Application of the corrected rate resulted in a $2,813 overstatement of claimed costs.

HCSC officials agreed with $141,493 of the $1,030,807 in FACP costs questioned. They did not agree with our findings related to the Millennium Project, Executive Salary Increase or Unallowable Travel Expense.

Transition Costs-$8,371,902

- Retention Bonuses and applicable fringe benefits totaling $7,905,171 were questioned, because HCFA rejected the contractors proposed retention plan as unreasonable. Many of these employees accepted positions with new contractors or were absorbed by the HCSC's private side.

- Other direct costs included in the transition claim were overstated by $374,629 for employee placement services that were included in the retention plan rejected by HCFA. Also, we have set aside $92,102 of consulting fees for HCFA's review and evaluation. The consultants charged time for work on the transition compensation program that was rejected by HCFA.

Termination Costs-$519,011

- Severance pay and applicable fringe benefits totaling $509,912 were questioned because HCFA had rejected the contractors' severance plan as unreasonable. The amount questioned represents the difference between severance pay calculated in accordance with the HCSC's approved plan (dated December 1995) and the amount claimed.

- Fixed asset net book values were overstated by $9,099.

HCSC officials provided a single response to the Transition and Termination costs questioned. They contend that these costs are allowable based on a written decision provided to HCSC by the HCFA Contracting Officer. The Contracting Officer did provide a decision that the types of costs included in HCSC's Transition Compensation Program were allowable. However the Contracting Officer specifically stated that such costs were allowable only if determined to be reasonable and allocable. The Contracting Officer did not make a decision on whether these costs were reasonable or allocable.

According to 48CFR 31, 201-3, a major consideration in determining the reasonableness of any cost claimed on a Government contract is whether a prudent businessman would have incurred such cost in a similar situation. In our opinion, a prudent businessman would not even consider incurring costs of this magnitude or announcing provisions of the plan to employees without first obtaining approval from the funding source. To the contrary, HCSC announced and implemented its plan without HCFA's approval.

Details of HCSC's response and our comment are provided with each finding. In addition HCSC's entire response is attached.

Unclaimed Costs:

- The HCSC incurred a total of $4,393,100 in fiscal years 1996 and 1997 that was not claimed. HCSC officials request that the unclaimed costs be offset against any questioned costs sustained by the contracting officer.

TABLE OF CONTENTS

G - Final Administrative Cost Proposal (Part A Totals)
October 1, 1996-September 30, 1997

H - Final Administrative Cost Proposal (Part B Totals)
October 1, 1996-September 30, 1997

I - Final Administrative Cost Proposal (Part A Totals)
October 1, 1997-September 30, 1998

J - Final Administrative Cost Proposal (Part B Totals)
October 1, 1997-September 30, 1998

K - Termination Cost Claim (Part A Totals)
October 1998-February 1999

L - Termination Cost Claim (Part B Totals)
October 1998-February 1999

Attachment – HCSC Response to the Draft Report

Doshi & Associates, P.C.

Accountants and Management Consultants
4520 Madison, Suite 105
Kansas City, Missouri 64111

Phone (816) 756-3020
Fax (816) 756-3021

Kant D. Doshi, C.P.A.

James R. Gray, C.P.A.

Manager:

Williams J. Anderson

INEPENDENT AUDITOR'S REPORT

OPINION

We have audited the "Final Administrative Cost Proposals" (FACP) of Health Care Services Corporation (HCSC) for the fiscal years ended September 30, 1998, 1997, 1996 and 1995. These financial statements are the responsibility of HCSC's 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 government auditing standards, "Government Auditing Standards," and the "Audit Guide For The Review of Administrative Costs Incurred By Medicare Intermediaries and Carriers under Title XVIII of The Social Security Act" (Audit Instruction E-1), dated February 25, 1991. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We have identified a total of $9,921,720 in costs recommended for financial adjustment. The final determination as to whether such costs are allowable will be made by the United States Department of Health and Human Services.

Excluded from our audit was a review of pension costs claimed and pension segmentation. This exclusion was directed by HHS-OIS.

In our opinion, with the exception of the ultimate resolution of the costs recommended for financial adjustment, the FACPs referred to above present fairly, in all material respects, the administrative costs applicable to Part A and Part B Health Insurance for the Aged and Disabled Program, claimed by HCSC for the fiscal years ended September 30, 1998, 1997, 1996 and 1995 in accordance with the reimbursement principles of Part 31 of the FAR as contained in 48 Code of Federal Regulations (CFR) Chapter(CH) 1, interpreted and modified by the Medicare Agreements.

This report is intended solely for the use of management within HCSC and the Department of Health and Human Services and should not be used for any other purpose.

Doshi & Associates PC

Doshi & Associates, P.C.

Kansas City, Missouri
July 29, 1999

INTRODUCTION

BACKGROUND

Health Insurance for the Aged and Disabled (Medicare) was established by Title XVIII of the Social Security Act. Hospital Insurance (Part A) provides protection against the cost of hospital and related care. Supplemental Medical Insurance (Part B) is a voluntary program that covers physician services, hospital outpatient services and certain other health services. The Health Care Financing Administration (HCFA) administers the Medicare Program. Under an agreement with HCFA, the Blue Cross and Blue Shield Association (BCBSA) participates as a Medicare Intermediary to assist in program administration.

Under a subcontract with BCBSA, HCSC received, reviewed, audited and paid Medicare Part A Claims in the states of Illinois and Michigan. Also during our audit period, Health Care Services Administration (HCSA), the Michigan intermediary, was a subsidiary of the HCSC.

Under a separate agreement with HCFA, HCSC and HCSA participated as Medicare carriers and performed the same functions for Medicare B in the same states.

Subject to limitations specified in the agreements, HCSC is entitled to reimbursement for reasonable administrative costs incurred. From October 1, 1994 through September 30, 1998, HCSC claimed $401,038,742 in administrative costs. In addition, HCSC submitted a termination claim totaling $3,673,905.

SCOPE

Our audit was conducted in accordance with generally accepted government auditing standards. The audit objective was to determine whether Medicare Parts A and B administrative costs claimed by HCSC on its "Final Administrative Cost Proposals" (FACP) were reasonable, allocable and allowable. We examined the administrative cost claimed by HCSC to determine whether the amounts are in accordance with (i) Federal Acquisition Regulations (FAR) part 31, (ii) the Carrier/Intermediary Manual, and (iii) the Medicare agreements. We also reviewed the reasonableness of salary increases given to certain HCSC executives that were charged to Medicare. In addition we audited HCSC's termination claim.

Our examination included audit procedures designed to achieve our objectives, and a review of accounting records and supporting documentation. The audit covered the period October 1, 1994 through September 1, 1998. Audit fieldwork was performed at HCSC offices in Chicago, Illinois from April through July 1999.

Our audit did not cover pension costs claimed and pension segmentation. A separate audit of HCSC pension plan for compliance with segmentation requirements will be performed at a later date.

FINDINGS AND RECOMMENDATIONS

FACP COSTS

Millennium Project

After receiving HCFA's notice of contract termination, HCSC continued allocating costs related to Y2K computer system revisions to Medicare. The HCSC did not obtain written approval to continue charging Medicare for that activity. We question whether Medicare will receive any benefit from the activity and are questioning the $738,759 that was charged to Medicare after HCSC had received notice of termination.

The HCSC established the Millennium Project to ensure its computerized systems are fully Y2K compliant by the year 2000. During calendar years 1997 and 1998, a total of $13.4 million was expended on the project. Costs were accumulated in cost centers 389 and 423 and allocated to all lines of business based on C.P.U. usage. A total of about $1.2 million was allocated to Medicare Part A and Part B in fiscal years 1997 and 1998.

Our review showed that costs charged to Medicare were recorded and allocated in accordance with HCSC's cost allocation system. However, we question whether Medicare should be allocated any of the project costs after the termination notification dated December 17, 1997.

The HCSC should have obtained a written agreement from HCFA to eliminate any doubts concerning the charges. Also, we contend that Medicare will not benefit from the Millennium project. According to 48CFR 31.201-4 a cost is allocable to a Government contract if it:

> *" Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received;"*

The Millennium Project was designed to avoid a computer problem in the year 2000. Benefits related to the project will accrue to all lines of business in operation at that date. Since the Medicare contract was terminated there will be no benefit to the contract after termination.

Recommendation

We recommend that HCSC make an adjustment of $738,759, as follows:

FY	Part A	Part B	Total
98	$639,210	$99,549	$738,759

HCSC Response

HCSC Officials did not concur with the finding. Those officials stated that Millennium Project expenses met FAR requirements for allowability and reasonableness. Also they cite FAR 31.204-4 that a cost is allowable to a contract if it benefits the contract and other work and can be distributed to them in reasonable proportion to benefits received; or is necessary to overall operation of the business although a direct relationship to a particular cost objective cannot be shown.

In addition those officials indicate that these activities were performed within HCSC's operating budgets for Medicare A and B. Further there was no requirement to secure prior agreement on Millennium compliance activities.

For the above reasons HCSC recommended that the questioned cost be allowed.

Auditor Comment

Prior to recommending disallowance of Millennium Project expenses, we did consider provisions of the FAR as related to the allowability of costs. Because HCSC had been notified on December 17,1997 that its Medicare contract would be terminated effective September 30, 1998, we considered the following:

(i) The project would not be completed until late 1999, which was 15 months beyond contract termination.

(ii) Project costs were not the ordinary type indirect expenses that HCFA had shared in previously.

(iii) A prudent businessman would not continue to share in the costs of a project that provided no foreseeable benefit.

Therefore, we concluded that HCSC should have received approval from HCFA to continue allocating these costs to Medicare after December 17, 1997 the date of termination notification.

Other Post Retirement Benefits

The HCSC overstated "other post-retirement benefits" by $122,759 in fiscal year 1996 because it did not fund future benefits in accordance with the Statement of Financial Accounting Standard (SFAS) No. 106 and applicable Federal Regulations.

The SFAS No. 106 requires that the expected costs of retiree health benefits be accrued during the employee's service years, rather than waiting for costs to be incurred during retirement years. Assets must be segregated and restricted to provide for future benefits.

Federal regulations at 48 CFR 31.206-6 (o) (2) state that post-retirement health benefit costs must be paid either to (i) an insurer, provider, or other recipient as current year benefits or premiums or (ii) an insurer or trustee to establish and maintain a fund or reserve for the sole purpose of providing health benefits to retirees. Retiree health benefit costs must be calculated in accordance with generally accepted actuarial principles and practices and be funded by the time set for filing the Federal income tax return. Retiree health benefit costs assigned to the current year, but not funded or otherwise liquidated by the tax return due date, are not allowable in a subsequent year.

During the period of audit, HCSC funded post retirement claims on a pay as you go basis. For example, retired employee health benefit claims were passed through the same accounts as used for active employees. The costs were allocated to all benefiting lines of business along with the active employee claims.

In addition, HCSC established a fund reserve in 1996 to provide future health benefits for retirees. The health care costs calculated for this reserve were allocated to all lines of business including Medicare. However, funding for the trust was made on a periodic basis not in accordance with Federal Regulations.

The HCSC recognized that funding was not in accordance with Federal Regulations. Therefore, the amount of charges to Medicare was eliminated from the FACP's for most years. Inadvertently, these charges were not eliminated in fiscal year 1996. We are questioning related costs of $122,759.

Recommendation

We recommend that HCSC make a financial adjustment of $122,759, as follows:

FY	Part A	Part B	Total
96	$24,725	$98,034	$122,759

HCSC Response

HCSC officials concur with the finding and recommendation.

Executive Salary Increases

The HCSC overstated the FACPs by $119,366 for executive salary increases, which exceeded the average increases for comparable positions as measured by the Department of Labor's Employment Costs Index (ECI).

Section 31.201-2(a) of FAR states that one of the factors to be considered in determining whether a cost is allowable, is whether the cost is reasonable.

Regarding reasonableness, FAR 31.205-6(b) states:

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

To assess the reasonableness of the executive increases, we included only those executives (Vice Presidents) that were charged direct to Medicare during the period audited. We compared the executive's base year compensation adjusted forward using the Bureau of Labor Statistics ECI for wages and salaries for executive, administrative, and managerial occupations.

The ECI represents dozens of indices that are calculated for various occupational and industry groups to measure the rate of change in employee compensation. It is a fixed weight index at the occupational level and eliminates the effects of employment shifts among occupations. The ECI is distinguished from other surveys in that it covers all establishments and occupations in both private and public sectors. We used the index for executive compensation because we considered it to be the most equitable and relevant measure.

We found that the executive salaries allocated to Medicare cost centers during fiscal years 1995 through 1998 included increases that exceeded the ECI. Because of personnel changes there were only three executives that remained in the analysis over the four-year period. Those three executives accounted for the $119,366 total compensation that exceeded ECI averages.

Recommendation

We recommend that HCSC make an adjustment of $119,366, as follows:

FY	Part A	Part B	Total
98	$39,908	$13,651	$ 53,559
97	27,772	17,694	45,466
96	14,959	3,740	18,699
95	1,415	227	1,642
Total	$84,054	$35,312	$119,366

Contractor Response

HCSC officials do not concur with the finding or recommendation. Those officials indicate that the ECI assumes on executive job function remained static during the audit period. However they contend the executives responsibilities actually increased and appropriate compensation adjustments were made.

Auditor Comment

The ECI was selected by HCFA as the applicable criteria for determining the reasonableness of executive salary increases. Our review showed that the salary increases exceeded the ECI. Therefore, we questioned the excess amounts.

Unallowable Travel Expenses

The HCSC claimed $31,189 in unallowable travel expenses. These travel expenses either exceeded the maximum limits as established in Federal Travel Regulations or were not properly supported.

According to 48CFR 31.205-46, the maximum reasonable and allowable travel costs for lodging, meals and incidental expenses are limited to the maximum per diem rates established for federal employees. Maximum per diem rates for federal employees are determined by the U.S. General Services Administration (GSA) for all locations in the continental United States. Established rates include components for lodging, meals and incidentals. Lodging rates are for single occupancy and room taxes. Incidental expenses include tips, laundry, dry cleaning and transportation to and from restaurants.

We selected a judgmental sample of 82 vouchers for review. Our review showed that HCSC claimed:

- $4,219 in meal & lodging expenses on 21 vouchers that exceeded allowable limits. In 4 of these instances, the traveler claimed meal expenses for other individuals.
- $4,286 in expenses on 3 vouchers where information was inadequate to determine any benefit to Medicare.
- $22,684 in travel costs on 12 vouchers where no support was provided.

The remaining 46 vouchers were properly supported.

Recommendation
We recommend that HCSC make an adjustment of $31,189, as follows:

FY	Part A	Part B	Total
98	$ 131	$ 758	$ 889
97	989	12,485	13,474
96	468	16,358	16,826
	$1,588	$29,601	$31,189

HCSC Response

HCSC officials do not concur. They take issue with the auditor's procedure of limiting the daily meal allowances to a single traveler on the four vouchers where several employees' meal expenses were claimed on one employees voucher. According to HCSC policy when employees are traveling the senior employee in attendance will pay for the meals of other employees in travel status. The senior employee will claim the total cost on his/her voucher. Based on that policy, HCSC officials contend that the meal allowance limit should be increased to include the allowance for all the employees that were traveling. HCSC officials provided no response or additional support for travel costs questioned on the other 32 vouchers.

Auditor Comment

FAR 31.205-46 provides the daily maximum allowable travel costs for lodging, meals and incidental expenses. These limits apply to Federal employees as well as government contractor employees. Daily limits are stated for a single traveler not for a group of travelers. The intent of these regulations is that each traveler will submit a claim for his/her own expenses. Also that procedure provides the necessary internal control to avoid duplicate charges for the same expense.

We limited the daily allowance to one traveler on the four vouchers. Also we requested the travel vouchers for the other employees to determine if the meal expenses were claimed twice. However HCSC did not provide the requested information. Because support was not provided, we questioned $789 in excess meal expenses on the four vouchers.

HCSC did not provide adequate support or information to eliminate the questioned items. Therefore, we believe the finding and recommendation should remain.

Unsupported Professional and Consultant Services Cost

We selected 14 invoices and related contractual agreements for audit. Our examination showed that the 14 invoices were properly authorized and each transaction recorded correctly. However HCSC could not locate contractual agreements to support two of the invoices. Therefore we could not verify that correct amounts were paid. We have questioned related costs of $15,921 as unsupported.

Recommendation

We recommend that HCSC make an adjustment of $15,921 as follows:

FY	Part A	Part B	Total
98	$ 8,681	$ 0	$8,681
97	1,882	5,358	7,240
Total	$10,563	$5,358	$15,921

HCSC Response

HCSC officials concur with the finding and recommendation.

Return on Investment (ROI)

The HCSC did not include accrued interest and other investment income of $7,823,603 in its FY 97 internal return on investment rate (ROI) calculation. The result of this error was to overstate the ROI rate.

We added the $7,823,605 to HCSC's FY 1997 Investment Asset Balance and recalculated a corrected ROI rate of 6.12% versus the proposed rate of 6.14%. Application of our corrected rate to the proposed Asset Book Values resulted in a reduction of $2,813 in ROI charges to Medicare.

Recommendation:

We recommend that HCSC make a financial adjustment of $2,813 as follows:

FY	Part A	Part B	Total
97	$ 1,198	$ 1,615	$ 2,813

HCSC Response

HCSC officials concur with the finding and recommendation.

TRANSITION AND TERMINATION COSTS

The HCSC claimed a total of $14,308,313 in transition and termination costs. Of that amount, we questioned a total of $8,798,811 and set aside $92,102 for HCFA's review and evaluation. The $8,789,712 was claimed for retention bonuses, severance pay and placement services that were included in a proposed transition compensation program rejected by HCFA. The amount set aside represents costs related to consulting services claimed for implementing the transition compensation program rejected by HCFA. Also, HCSC overstated its fixed asset disposition costs by $9,099.

Background on Transition Compensation Program

One of HCSC's major concerns relating to the transition effort was maintaining an adequate workforce to ensure a proper and timely transition. To this goal, HCSC established a Transition Compensation Program (Program) consisting of three parts: a retention plan, a management contingent compensation plan, and a severance plan. This Program was developed after the notice of termination, dated December 17, 1997.

The HCSC submitted the Program to HCFA on February 25, 1998 and requested an approval by March 3, 1998. However, the cost estimate was not submitted to HCFA until March 3, 1998. The HCFA provided a response to HCSC on March 9, 1998 that stated;

> "As we have previously advised, we do not approve your proposed new Transition Compensation Program. While we recognize that the Federal Acquisition Regulations and your Medicare contracts allow for the possibility for payment of severance payments, these payments are only allowable to the extent that they were provided for in an approved and existing employer-employee agreement. We, therefore, cannot recognize any attempts to amend the existing employer-employee agreements but must be governed by those in existence prior to the date of the actions that led to your announcement that you would be leaving the Medicare program."

Our analysis of the Program costs paid during the transition period January 1, 1998 through September 30, 1998 showed the following:

Schedule of Bonus and Severance Payments

Action Taken	Total Employees Affected	Retention		Severance		Mgmt Incentive		
		Employees	Amount	Employees	Amount	Employees	Amount	Total
Governmental								
Terminated	56		$ 0		$ 0		$ 0	$ 0
Severed	37	37	614,902	37	922,026	12	176,316	1,713,244
Transferred within HCSC	205	132	1,330,505			13	216,384	1,546,889
Transferred to New Contractor	888	599	5,841,799	0	0	37	323,682	6,165,481
Undocumented (a)			117,965					117,965
Total (b)	1,186	768	$ 7,905,171	37	$ 922,026	62	$ 716,382	$ 9,543,579
Summary								
Bonus & Severance Payments			$ 7,404,553		$ 807,685		$551,063	8,763,301
Fringe Benefits			500,618		114,341		165,319	780,278
Total			$ 7,905,171		$ 922,026		$ 716,382	$ 9,543,579

Although HCFA rejected the proposed program, HCSC announced and distributed copies of the Program to effected employees on March 9, 1998.

The total cost of this Program was $9,543,579, including $8,763,301 in bonuses and $780,278 in related fringe benefits. The HCSC has paid its employees and claimed the costs. In addition to the Program costs, the effected employees received a total of $18,945,124 in regular salaries and fringe benefits. For the 9-month period, the total Program and regular compensation was $28,488,708.

Our review of the Program components resulted in recommended adjustments to the Retention Plan and Severance plan, totaling $7,905,171 and $509,912, respectively. An analysis of the retention payments and our recommended adjustments to severance payments are provided in the findings titled, "Unallowable Retention Bonuses" and "Severance Pay".

Regarding the Management Contingent Compensation plan, HCSC had designed a performance program for its officers, managers and senior professional positions in the Medicare line of business that was contingent upon the successful transition of Medicare functions to the new contractors. This plan contained only minor modifications in the plan that was previously applied to the Medicare management group. We concluded that the Management Contingent Compensation plan was reasonable and allowable.

The HCSC claimed $551,063 in management contingent compensation plus $165,319 in fringe benefits for the 9-month transition period. We determined the amounts paid for the transition period January through September 1998 were reasonable as compared to amounts paid in prior periods. Therefore, we consider these costs to be allowable.

HCSC Response

HCSC Officials disagree with all recommendations relating to the Medicare Transition Compensation Program. Those recommendations include the following questioned amounts:

Item	Questioned Amount
Retention Bonuses	7,905,171
Severance Pay	509,912
Placement Service	374,629
Consulting Fees (Set Aside)	92,102
Total	$8,881,814

Details relating to each finding are provided in this report under separate caption.

HCSC officials provided the following response;

> *"These recommendations are based on Health Care Financing Administration ("HCFA") correspondence in which HCFA relied on Federal Acquisition Regulations ("FAR") 31.205-6 to disapprove the Program. In its claim to the Contracting Officer, Health Care Service Corporation disputed HCFA's position that FAR 31.205-6 prohibits HCSC form implementing new or modifying existing compensation programs without HCFA's approval. On May 6,1999, the Contracting Officer made a final decision regarding the Program.*
> *Specifically, he ruled:*
> *" After reviewing the documentation submitted by HCSC and the pertinent sections of the Federal Acquisition Regulations (FAR), I have concluded that bonus retention payments and severance costs are costs which are generally allowable under FAR 31.205-6. Consequently, it is my determination that the bonus retention payments and severance costs included in HCSC's compensation program are allowable."*
>
> *Therefore, the auditor's, as well as, HCFA's reliance on FAR 31.205-6 is in direct contradiction with the Contracting Officer's final decision."*

In conclusion, HCSC recommended the entire cost of the Medicare Compensation Program be allowed except for the $117,965 variance in transition bonuses claimed that were not supported.

Auditor Comment

HCSC quoted only part of the contracting officers final decision. In addition to the quotation cited in HCSC's response the contracting officer stated;

> *"While I have determined that these costs are allowable under FAR 31.205-6, please note that under FAR 31.201-2, to be allowable, costs must also be reasonable and allocable. Section 31.203-3 of the FAR provides that "[I]f an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable." Consequently, so that we may determine the reasonableness and allocability of HCSC's claimed costs, please provide the documentation, studies, reports, and underlying facts HCSC used to develop its compensation program.*
>
> *This contracting officer final decision applies only to the allow ability of the types of costs claimed, not to the reasonableness nor allocability of the actual costs claimed by HCSC. As HCSC has not submitted a claim in sum certain, it is not entitled to a contracting officer final decision regarding the specific costs of the program. As you are aware, the Department of Health and Human Services' Officer of the Inspector General is currently conducting an audit of the costs associated with HCSC's Final Administration Cost Proposals (FACP), vouchers, termination program, and transition program as part of the process of closing out HCSC's Medicare Part agreement and Part B contract. I consider HCSC's FACPs and vouchers to be routine requests for payment and, at this point, not in dispute. After reviewing the above-requested documentation, audit findings, and costs associated with HCSC's compensation program, the Health Care Financing Administration will determine the reasonableness and allocability of the specific costs incurred by HCSC and make appropriate adjustments to any payments due your organization."*

In separate correspondence from the HCFA Regional Associate Administrator, dated March 9, 1998 and May 5, 1998, HCSC was told the proposed Transition Compensation Plan was unreasonably excessive. Also, the Associate Administrator advised HCSC that severance payments would only be allowable to the extent that they were in an approved and existing employer-employee agreement.

We believe the Contracting Officer's decision was very clear that the types of costs included in the transition compensation plan would be allowable only if determined to be reasonable and allocable. The Associate Administrator told HCSC officials that the proposed retention and severance compensation plan was not reasonable. However, HCSC announced its plan to the effected employees before HCFA could reach an agreement on a reasonable plan. Therefore, we questioned the costs claimed.

Considering the above, we prepared schedules that provide total severance payments, retention bonuses, salaries and management incentive payments paid to each employee during the nine-month transition period. Also, we compared the severance payments made to each employee under HCSC's revised plan to the plan in effect at termination notification date. These schedules should assist the contracting officer in resolving the issues.

Retention Bonuses

The HCSC claimed a total of $7,404,553 in retention bonuses paid to 768 employees plus $500,618 in related fringe benefits. Those bonuses were paid under a retention plan that HCFA had rejected as excessive and unreasonable. Therefore, we have questioned the total of $7,905,171.

Under HCSC's retention bonus plan, an employee received the regular weekly salary plus a 50 percent bonus. The bonus was contingent on the employee working his/her entire designated transition period. Payment for the bonus was two weeks following the employee's successful completion of the designated transition period.

The HCFA reviewed the retention plan and provided its specific concerns to HCSC in a letter, dated May 5, 1998, that stated;

> *"We have examined the current proposal, and we believe it is not reasonable and therefore, not allowable. We question, for example, the amount of the proposed incentive payment and the scope of employees eligible for incentive payments. Our concern is that a bonus of one-half (50%) of current weekly base pay in addition to regular base pay is unreasonably excessive. We are unaware of any contractor that terminated its contract with Medicare providing staff with a 50% bonus retention package. In addition, providing a retention package for those individuals being subsumed by the incoming contractors is unnecessary and not in the government's best interest."*

The HCSC did not agree with HCFA's position and implemented the plan. The total payments were claimed on the fiscal year 1998 FACP under Part A and Part B. The HCFA did not reimburse HCSC for its claim.

Our review of retention bonuses showed that HCSC had calculated the amounts accurately. However, we identified only $7,286,588 in retention payments, or $117,965 short of the amount claimed. The HCSC officials were advised of the variance and, as yet, no explanation has been provided. Those officials indicated that the problem is being researched.

An analysis of total compensation paid the 768 employees during the transition period January 1, 1998 through September 30, 1998 showed the following;

- All 37 employees that were severed received both retention and severance payments. Also, 13 of those employees received management incentives. Total compensation including regular salaries paid to the 37 employees was:

Retention Bonuses	$ 614,902
Severance Pay	922,026
Mgmt. Incentives	176,316
Subtotal	$1,713,244
Regular Salaries	1,494,619
Total	$3,207,863

  In addition to the compensation each severed employee received free employment placement services. (See finding on Placement Services).

- There were 205 employees that transferred within HCSC, and 132 of those employees received retention bonuses. Also, 13 were paid management incentives. Total compensation including regular salaries paid the 132 employees was:

Retention Bonuses	$1,330,505
Mgmt. Incentives	216,384
Subtotal	$ 1,546,889
Regular Salaries	3,238,038
Total	$4,784,927

  All 132 employees transferred within HCSC were assigned to new positions immediately upon completing their respective transition dates.

- There were 888 employees that transferred to new contractors. Of those employees, 599 received retention bonuses, and 37 also received management incentives. Total compensation including regular salaries paid the 599 employees was:

Retention Bonuses	$ 5,841,799
Mgmt. Incentives	323,682
Subtotal	$ 6,165,481
Regular Salaries	14,212,473
Total	$ 20,377,954

  Each of these employees had accepted employment with the new contractor before completing their transition dates at HCSC. The 289 employees that did not receive retention bonuses were mostly union employees.

During the 9-month transition period HCSC claimed a total of $28,488,708 in compensation payments to 768 employees.

As previously stated, HCFA rejected the retention bonus plan as excessive and unreasonable. Therefore, we have questioned the total retention bonuses and related fringe benefits.

Recommendation

We recommend that the HCSC make an adjustment of $7,905,171, as follows;

FY	Part A	Part B	Total
98	$ 2,295,764	$5,609,401	$7,905,171

HCSC Response and Auditor Comment presented on page 12 of this Report.

Severance Pay

The HCSC paid 37 employees severance amounts, totaling $922,026. Those payments were based on a revised severance plan that was issued after the termination notification date. The HCFA did not approve the revised plan. We computed the allowable severance amounts based on the plan in effect at the termination notification date. Based on our computation, we determined that HCSC had overstated severance pay and related fringe benefits by $509,912.

Regarding HCSC's revised severance plan, HCFA provided the following response:

> *"While we recognize that the Federal Acquisition Regulations and your Medicare contracts allow for the possibility for payment of severance payments, these payments are only allowable to the extent that they were provided for in an approved and existing employer-employee agreement. We therefore cannot recognize any attempts to amend the existing employer-employee agreements but must be governed by those in existence prior to the date of the actions that led to your announcement that you would be leaving the Medicare program."*

The HCFA had approved a severance plan for the HCSC in December 1995. The revised plan, as proposed and applied by HCSC, provided considerable increases in severance benefits.

The HCSC used the revised plan to calculate each employee's severance pay and related fringe benefits. Our review showed that the employee's severance amounts and fringe benefits were calculated accurately and in accordance with the revised plan.

We calculated the allowable severance amounts based on the plan approved in December 1995. Provisions of that plan were applied to the employee's date of tenure and base salary amounts as provided by HCSC. Our calculation of severance pay resulted in a total of $397,004, as compared to HCSC's $807,685. The difference of $410,681 is unallowable.

In addition to the severance pay, HCSC proposed $114,341 in related fringe benefits. That amount included $83,504 in medical and dental insurance, plus $30,837 in FICA and Medicare taxes. Because medical and dental insurance was not included in the December 1995 plan, we have questioned the $83,504. Also, we are recommending an adjustment of $15,727 in FICA and Medicare taxes related to the severance amounts questioned.

The total severance payments and fringe benefits questioned is $509,912. We allocated that amount between Part A and B based on the ratios in the termination claim.

Recommendation

We recommend the HCSC make an adjustment of $509,912, as follows:

	Part A	Part B	Total
Severance Pay:	$176,593	$234,088	$410,681
Fringes:	35,274	48,230	83,504
FICA/Medicare	6,763	8,964	15,727
Total	$218,630	$291,282	$509,912

HCSC Response and Auditor Comment presented on page 12 of this Report.

Placement Services

The HCSC included group and placement services for its employees as part of the revised severance plan. That plan was rejected by HCFA as being unreasonable. However, the HCSC claimed $374,629 of placement services expense in its transition costs. The total claimed for those services is questioned.

The HCSC entered into a contract with Clarke Poynton & Associates, Chicago, Illinois to provide services for its employees during the transition phase. The contract provided for a ceiling of $400,000. We reviewed disbursement ledgers and found that HCSC claimed a total of $374,629. That amount included $165,309 and $209,320 for group and individual counseling, respectively.

An analysis of Clarke Poynton's invoices for individual counseling provided the following information related to final placement action and cost of service for those employees:

- Five employees transferred to the new Medicare contractor and HCSC paid $18,905 in placement costs. Two of these employees received retention bonuses totaling $41,485.

- Twenty-one employees were severed and HCSC paid $111,605 in placement costs. All of these employees received retention bonuses and severance payments. Total retention and severance costs were $374,659 and $659,889, respectively.

- Eighteen employees were transferred within HCSC and placement costs of $78,810 were paid. Three of these employees received a total of $217,717 in retention bonuses.

In our opinion, payments to the placement firm were unnecessary. All of the employees had the option to apply for employment with the new contractor and, if employment was denied, severance would be paid. One intention of the severance payment was to assist the employee until employment was found elsewhere. Also, it is an industry practice that when an individual utilizes an employment service to obtain employment, the placement fee is paid either by the hiring firm or the individual. The employee's prior employer rarely pays the fee.

Because HCFA did not approve the HCSC severance plan, which included the placement services, and for the reasons stated above, we have questioned the total claimed of $374,629.

Recommendation

We recommend that HCSC make an adjustment of $374,629, as follows:

FY	Part A	Part B	Total
98	$187,315	$187,314	$374,629

HCSC Response and Auditor Comment presented on page 12 of this Report.

Consulting Fees

The HCSC contracted with the Arthur Anderson Consulting firm to assist in planning, monitoring and implementing the transition program. An undetermined amount of the consulting firm's effort was expended on planning and monitoring the Transition Compensation Program. That Program was not approved by HCFA. Consequently, we recommend those invoices with charges relating to the compensation program be set aside for HCFA's review and evaluation.

We identified nine billings where four consultants described effort that was expended on the Transition Compensation Program. However, we could not determine the actual hours and costs billed for those services. The billings provided only total hours worked on all activities by those consultants.

We have identified the specific services, total hours and total amounts billed for each consultant on the nine billings. The total amount billed for the consultants was $92,102. That information was provided to HCSC officials, and we asked that they have the consultants provide a breakdown of hours and costs for each time entry that relates to the Transition Compensation Program. We have not received the requested information.

Recommendation

We recommend that:

1. The $92,102 be set aside for further review and evaluation by HCFA officials.

FY	Part A	Part B	Total
98	$46,051	$46,051	$92,102

2. The HCSC obtain the detailed breakdown of hours and costs related to the Transition Compensation Program and provide that information to HCFA.

HCSC Response and Auditor Comment presented on page 12 of this Report.

Fixed Assets Overstated

The HCSC overstated the net book value of fixed assets by $9,099 on the termination claim. The overstated amount is questioned.

Representatives from HCFA performed a physical inventory of fixed assets in the termination inventory. We verified the net book value of each item to HCSC's books of record. Our review showed that the Part A inventory was overstated $9,099.

Recommendation

We recommend that HCSC make an adjustment of $9,099 to the Part A termination claim.

HCSC Response

HCSC officials concur with the finding and recommendation.

OTHER MATTERS

Unclaimed Costs

The HCSC had incurred a total of $4,393,100 in costs under Medicare Part A in fiscal years 1997 and 1996 that was not claimed. Those costs were recorded in the HCSC's Cost Recording System (CRS) during the fiscal year and removed from the final FACP by a credit adjustment, as follows.

FY	Part A	Note
1997	$4,238,100	(a)
1996	155,000	(b)
Total	$4,393,100	

Notes

(a) The adjustment in fiscal year 1997 was $(3,362,940) in Bills Payment and ($875,160) in Medical Review and Utilization activities.

(b) The adjustment in fiscal year 1996 was ($155,000) in the Other Expense Category of Bills Payment.

Disposition of Fixed Assets

Except for fixed assets with a total net book value of $380,799, HCSC had disposed of its furniture and equipment that was dedicated to Medicare operations. The HCFA officials have monitored the entire process and verified the physical existence and condition of the remaining items. According to HCFA officials, disposition of the remaining items should be completed by the end of September 1999. We verified the net book value of the remaining assets. (See our finding Fixed Assets Overstated).

Follow up on Prior Findings

The HCFA performed a Risk Assessment Analysis at HCSC that covered Medicare costs claimed for fiscal years 1991 through 1994. Recommended financial adjustments of $98,627 were made as a result of that study. The HCSC paid the recommended financial adjustment by check to HCFA on January 21, 1998.

Medicare Benefits Paid

The Medicare benefits paid by HCSC during the audit period were, as follows:

Part A

Fiscal Year	Illinois	Michigan	Total
1995	$ 5,444,630,678	$ 3,729,932,790	$ 9,174,563,468
1996	5,698,183,205	3,946,181,982	9,644,365,187
1997	5,901,185,353	4,035,861,744	9,937,047,097
1998	5,020,098,913	4,108,208,618	9,128,307,531

Part B

Fiscal Year	Illinois	Michigan	Total
1995	$ 1,466,890,185	$ 1,411,257,229	$ 2,878,147,414
1996	1,477,799,542	1,629,064,667	3,106,864,209
1997	1,481,865,445	1,660,319,544	3,142,184,989
1998	1,267,986,040	1,414,845,302	2,682,831,342

HEALTH CARE SERVICE CORPORATION
FINAL ADMINISTRATIVE COST PROPOSAL
AND AUDITORS RECOMMENDATIONS - PART A(IL)
FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 1995

Operation		Administrative Costs
Bills Payment	$	9,023,982
Recons & Hearings		169,236
Medicare Secondary Payer		2,490,041
Medical Rev & Util Rev.		1,174,985
Provider Desk Reviews		3,567,011
Provider Field Audits		1,187,773
Provider Settlements		1,055,483
Provider Reimbursement		2,257,176
Productivity Investments		-
Benefit Integrity		124,459
Other		-
Other		(406,952)
Total FACP Costs Claimed	$	20,643,194
Recommended Adjustments:		
Executive Salary Costs		(1,415)
Total Costs Questioned	$	(1,415)
Total Costs Recommended for Acceptance	$	20,641,779

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

HEALTH CARE SERVICE CORPORATION
FINAL ADMINISTRATIVE COST PROPOSAL
AND AUDITORS RECOMMENDATIONS - PART A(MI)
FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 1995

Operation		Administrative Costs
Bills Payment	$	7,337,774
Recons & Hearings		203,809
Medicare Secondary Payer		2,694,662
Medical Rev & Util Rev.		1,103,966
Provider Desk Reviews		1,669,962
Provider Field Audits		1,168,467
Provider Settlements		899,305
Provider Reimbursement		1,152,985
Productivity Investments		-
Benefit Integrity		150,099
Other		-
Other		(1,076,770)
Total FACP Costs Claimed	$	15,304,259
Recommended Adjustments:		-
Total Costs Questioned		-
Total Costs Recommended for Acceptance	$	15,304,259

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

HEALTH CARE SERVICE CORPORATION
FINAL ADMINISTRATIVE COST PROPOSAL
AND AUDITORS RECOMMENDATIONS - PART B(IL)
FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 1995

Operation	Administrative Costs
Claims Payments	$ 22,570,091
Reviews and Hearings	2,084,022
Beneficiary/Phys. Inquiry	4,557,074
Provider Ed and Training	1,607,855
Medical Rev & Util Rev	3,912,586
Medicare Secondary Payer	2,789,552
Participating Physician	770,803
Productivity Investment	761,812
Other	(5,270,061)
Benefit Integrity	2,050,117
Other	2,974,386
Total FACP Costs Claimed	$ 38,808,237
Recommended Adjustments:	
Executive Salary Costs	(227)
Total Costs Questioned	$ (227)
Total Costs Recommended for Acceptance	$ 38,808,010

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

HEALTH CARE SERVICE CORPORATION
FINAL ADMINISTRATIVE COST PROPOSAL
AND AUDITORS RECOMMENDATIONS - PART B(MI)
FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 1995

Operation		Administrative Costs
Claims Payments	$	23,382,791
Reviews and Hearings		3,173,722
Beneficiary/Phys. Inquiry		4,242,908
Provider Ed and Training		2,516,467
Medical Rev & Util Rev		1,952,158
Medicare Secondary Payer		3,796,275
Participating Physician		622,003
Productivity Investment		188,955
Other		(5,101,341)
Benefit Integrity		1,164,263
Other		53,000
Total FACP Costs Claimed	$	35,991,201
Recommended Adjustments:		-
Total Costs Questioned		-
Total Costs Recommended for Acceptance	$	35,991,201

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

HEALTH CARE SERVICE CORPORATION
FINAL ADMINISTRATIVE COST PROPOSAL
AND AUDITORS RECOMMENDATIONS - PART A
FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 1996

Operation	Administrative Costs
Bills Payment	$ 17,049,570
Recons & Hearings	554,099
Medicare Secondary Payer	4,817,578
Medical Rev & Util Rev.	2,952,272
Provider Desk Reviews	4,246,196
Provider Field Audits	3,943,134
Provider Settlements	1,978,172
Provider Reimbursement	2,342,619
Productivity Investments	28,386
Benefit Integrity	486,534
Other	95,000
Other	(1,990,049)
Total FACP Costs Claimed	$ 36,503,511
Recommended Adjustments:	
Unallowable Other Post Ret. Benefits	(24,725)
Executive Salary Costs	(14,959)
Unallowable Travel Expenses	(468)
Total Costs Questioned	$ (40,152)
Total Costs Recommended for Acceptance	$ 36,463,359

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

HEALTH CARE SERVICE CORPORATION
FINAL ADMINISTRATIVE COST PROPOSAL
AND AUDITORS RECOMMENDATIONS - PART B
FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 1996

Operation	Administrative Costs
Claims Payments	$ 42,120,042
Reviews and Hearings	4,874,196
Beneficiary/Phys. Inquiry	10,172,388
Provider Ed and Training	2,840,603
Medical Rev & Util Rev	5,884,999
Medicare Secondary Payer	3,484,703
Participating Physician	612,607
Productivity Investment	275,253
Credits	(12,060,295)
Benefit Integrity	3,055,482
Other	2,929,661
Total FACP Costs Claimed	$ 64,189,639
Recommended Adjustments:	
Unallowable Other Post Ret. Benefits	(98,034)
Executive Salary Costs	(3,740)
Unallowable Travel Expenses	(16,358)
Total Costs Questioned	$ (118,132)
Total Costs Recommended for Acceptance	$ 64,071,507

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

HEALTH CARE SERVICE CORPORATION
FINAL ADMINISTRATIVE COST PROPOSAL
AND AUDITORS RECOMMENDATIONS - PART A
FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 1997

Operation		Administrative Costs
Bills Payment	$	14,662,635
Recons & Hearings		1,007,005
Medicare Secondary Payer		4,248,557
Medical Rev & Util Rev.		2,953,313
Provider Desk Reviews		5,362,115
Provider Field Audits		1,856,250
Provider Settlements		2,235,422
Provider Reimbursement		2,787,367
Productivity Investments		94,316
Benefit Integrity		833,143
MIP Other		29,500
Credits/Other		(2,087,780)
Total FACP Costs Claimed	$	33,981,843
Recommended Adjustments:		
Executive Salary Costs		(27,772)
Unallowable Travel Expenses		(989)
Unsupported Professional & Consultant Costs		(1,882)
Return on Investment		(1,198)
Total Costs Questioned	$	(31,841)
Total Costs Recommended for Acceptance	$	33,950,002

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

HEALTH CARE SERVICE CORPORATION
FINAL ADMINISTRATIVE COST PROPOSAL AND AUDITORS RECOMMENDATIONS - PART B FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 1997

Operation		Administrative Costs
Claims Payments	$	39,777,574
Reviews and Hearings		4,149,493
Beneficiary/Phys. Inquiry		10,171,336
Provider Ed and Training		1,746,316
Medical Rev & Util Rev		6,022,254
Medicare Secondary Payer		3,799,806
Participating Physician		1,968,096
Productivity Investment		-
Credits/Other		(10,545,842)
Benefit Integrity		3,546,598
Other		1,296,821
Total FACP Costs Claimed	$	61,932,452
Recommended Adjustments:		
Executive Salary Costs		(17,694)
Unallowable Travel Expenses		(12,485)
Unsupported Professional & Consultant Costs		(5,358)
Return on Investment		(1,615)
Total Costs Questioned	$	(37,152)
Total Costs Recommended for Acceptance	$	61,895,300

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

HEALTH CARE SERVICE CORPORATION
FINAL ADMINISTRATIVE COST PROPOSAL
AND THE AUDITORS RECOMMENDATIONS - PART A
FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 1998

Operation	Administrative Costs
Medical Review	$ 2,299,080
Medicare Secondary Payer	5,534,412
Benefits Integrity	1,073,777
Provider Educ & Training	89,030
Audit	6,964,878
Bills Claims Payment	12,227,632
Appeals/Reviews	841,714
Inquiries	2,202,769
Provider Educ & Training	2,582,434
Reimbursement	2,993,347
Productivity Investment	3,722,744
Credits	(2,106,634)
Total FACP Costs Claimed	$ 38,425,183
Recommended Adjustments:	
Millennium Project	(639,210)
Executive Salary Costs	(39,908)
Unallowable Travel Expenses	(131)
Unsupported Professional & Consultant Costs	(8,681)
Retention Salaries & Fringes	(2,295,764)
Placement Services	(187,315)
Total Costs Questioned	$ (3,171,009)
Cost Set Aside	
Consulting Fees	(46,051)
Total Recommended Adjustment	$ (3,217,060)
Total Recommended for Acceptance	$ 35,208,123

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

HEALTH CARE SERVICE CORPORATION
FINAL ADMINISTRATIVE COST PROPOSAL
AND AUDITORS RECOMMENDATIONS - PART B
FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 1998

Operation		Administrative Costs
Medical Review	$	4,743,601
Medicare Secondary Payer		3,533,533
Benefits Integrity		2,260,660
Provider Educ & Training		366,611
Bills Claims Payment		35,045,962
Appeals/Reviews		2,712,894
Inquiries		8,280,238
Provider Educ & Training		2,400,335
Participating Physician		227,709
Productivity Investment		6,928,823
Credits		(11,241,143)
Total FACP Costs Claimed	$	55,259,223
Recommended Adjustments:		
Millennium Project		(99,549)
Executive Salary Costs		(13,651)
Unallowable Travel Expenses		(758)
Retention Salaries & Fringes		(5,609,407)
Placement Services		(187,314)
Total Costs Questioned	$	(5,910,679)
Cost Set Aside		
Consulting Fees		(46,051)
Total Recommended Adjustments	$	(5,956,730)
Total Recommended for Acceptance	$	49,302,493

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

HEALTH CARE SERVICE CORPORATION
PART A TERMINATION COST CLAIM AND
AUDITORS RECOMMENDATIONS

Item/Account	Proposed Cost
Severance Pay	$ 344,723
Medical/Dental Insurance	35,274
Fica/Medicare Tax	17,659
Subtotal Severance	$ 397,656
Fixed Assets (NBV) Not Taken	241,225
Other Direct Medicare Cost	145,717
Indirect Cost	551,294
Total Part A Claim	$ 1,335,892
Recommended Adjustments:	
Severance Pay	(218,630)
Fixed Assets Overstated	(9,099)
Total Questioned	$ (227,729)
Total Costs Recommended For Acceptance	$ 1,108,163

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

HEALTH CARE SERVICE CORPORATION
PART B TERMINATION COST CLAIM AND
AUDITORS RECOMMENDATIONS

Item/Account	Proposed Cost
Severance Pay	$ 462,960
Medical/Dental Insurance	48,230
Fica/Medicare Tax	13,179
Subtotal Severance	$ 524,369
Fixed Assets (NBV) Not Taken	
NBV of Assets not taken	139,574
Other Direct Medicare Cost	978,355
Indirect Cost	695,711
Total Part B Claim	$ 2,338,009
Recommended Adjustments:	
Severance Pay	(291,282)
Total Questioned	$ (291,282)
Total Costs Recommended For Acceptance	$ 2,046,727

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

BlueCross BlueShield
of Illinois

An Independent Licensee of the
Blue Cross and Blue Shield Association

300 East Randolph Street
Chicago, Illinois 60601-5099
312-653-6869

J. Kenneth Jansson
Vice President
Audit and Performance Review

November 18, 1999

Kant D. Doshi
Doshi & Associates
4520 Madison, Suite 105
Kansas City, Missouri 64111

Re: Medicare Administrative Cost Audit Response

Dear Mr. Doshi:

Enclosed is Health Care Service Corporation's response to the Medicare Administrative Cost Audit Draft report, which was received on October 18, 1999.

We have tried to reference our responses to your draft report to facilitate the incorporation of the responses into the final report. If there are any questions or if any findings change as a result of our response, please contact me before the final report is issued.

Sincerely,

Ken Jansson

J. Kenneth Jansson

cc: D.A. Bujak
C. Clift
M.W.Ellis
T.D. Gurber
E.M. Hunt
H. Tagli

Responses to Administrative Cost Audit
Draft Report

Health Care Service Corporation
Chicago, Illinois

Fiscal Years Ended September 30, 1995, 1996,
1997, 1998 and Termination Claim

Responses to findings

Health Care Service Corporation (HCSC) received the Medicare Administrative Cost Audit Draft Report dated October 7, 1999 on October 18, 1999. This report was prepared by the firm of Doshi and Associates and approved for release by the Office of Inspector General, Office of Audit, Department of Health & Human Services.

Following are HCSC's responses to the findings:

FACP Costs:

Millennium Project Costs

HCSC does not agree with this finding.

- There are no FAR, CAS or Contract provisions that address the specific accounting treatment of Millenium compliance. Therefore, Generally Accepted Accounting Principals apply. In accordance with these practices, HCSC is expensing Millennium costs as incurred. Expenses are allocated at the time they are incurred. The audit finding suggests that HCSC should not allocate these costs to Medicare because of an anticipated future event. In our non-government business HCSC is continually transitioning in and out of other business. If HCSC were to evaluate future events each time a cost allocation was performed, the allocation system would be constantly subjected to the uncertainties of future events, leading to misallocation to the government business.
- Millennium compliance activities and expenses meet the requirements in FAR 31.201-2 (Allowability) and FAR 31.201-3 (Reasonableness). FAR 31.201-4 states that a cost is allocable to a government contract if it "benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; **or is necessary to the overall operation of the business, although a direct relationship to a particular cost objective cannot be shown".**

- HCFA never provided HCSC with separate or specific funding for Millennium expenses. These activities were performed within HCSC's operating budgets for Medicare A and B. HCSC had discretion on how to manage and spend the operating budgets. There was no requirement to secure prior agreements on Millennium compliance activities.

Recommendation:

Based on the above, the questioned costs of $738,759 should be allowed.

Other Post Retirement Benefits

HCSC does not currently dispute this finding.

Executive Salary Increases

HCSC disagrees with this audit finding and the strict use of the Employment Cost Index (ECI) to determine reasonable salary levels.

The use of the ECI assumes that an individual's job function remains static over the time period being reviewed. During this audit period the individuals identified had increases in their scope of responsibilities, with appropriate adjustments in compensation.

The HCSC salary structure is reviewed and updated annually. Salary levels are set to be competitive within the industry and geographic location. The FAR does not require that the ECI be the only method of salary determination. FAR 31.205-6(b) states in part:

> "The compensation for personal services paid or accrued must be reasonable for the work performed. Compensation will be considered reasonable if each of the allowable elements making up the employee's compensation package is reasonable. In determining the reasonableness of individual elements for particular employees or classes of employees, consideration should be given to all potentially relevant facts. Facts which may be relevant include general conformity with the compensation practices of other firms of the same size, the compensation practices of other firms in the same industry, the compensation practices of other firms in the same geographic area, the compensation practices of firms engaged in predominately non-Government work and the cost of comparable services obtainable from outside sources."

Recommendation:

Based on the above, the questioned costs of $119,366 should be allowed.

Unallowable Travel Expenses

HCSC disputes the use of one traveler's meal allowance when that traveler is paying for a group meal. HCSC's policy is when employees are traveling the senior employee in attendance pays for the meal. This is the case for the four instances cited. However, the auditors only allowed a single meal allowance when multiple traveling employees were present. HCSC feels that when the senior employee pays for the meal, the limit should be increased to include the meal allowance for all the attendees that were traveling. As it stands now, if five traveling employees had dinner and the senior employee paid, only one meal is being allowed. This conceptually is not the intent of the travel limits.

Recommendation:

Based on the above, the questioned costs should be allowed.

Unsupported Professional and Consultant Services Cost

HCSC does not currently dispute this finding.

Return on Investment (ROI)

HCSC does not currently dispute this finding.

Transition and Termination Costs:

Retention Bonuses/Severance Pay/Placement Services (Medicare Transition Compensation Program)

Health Care Service Corporation disagrees with all recommendations made by the auditors in connection with the Medicare Transition Compensation Program (the "Program"). These recommendations are based on Health Care Financing Administration ("HCFA") correspondence in which HCFA relied on Federal Acquisition Regulations ("FAR") 31.205-6 to disapprove the Program. In its claim to the Contracting Officer, Health Care Service Corporation disputed HCFA's position that FAR 31.205-6 prohibits HCSC from implementing new or modifying existing compensation programs without HCFA's approval. On May 6, 1999, the Contracting Officer made a final decision regarding the Program. Specifically, he ruled:

> "After reviewing the documentation submitted by HCSC and the pertinent sections of the Federal Acquisition Regulations (FAR), I have concluded that bonus retention payments and severance costs are costs which are generally allowable under FAR 31.205-6. Consequently, it is my

determination that the bonus retention payments and severance costs included in HCSC's compensation program are allowable."

Therefore, the auditor's, as well as, HCFA's reliance on FAR 31.205-6 is in direct contradiction with the Contracting Officer's final decision.

HCSC will reflect the $117,965 variance identified as a credit in the termination voucher. The cost is being reflected in this way since it is no longer possible to amend the FACP.

Recommendation:

The entire cost of the Medicare Compensation Program should be allowed, except for the $117,965 variance.

Consulting Fees

HCSC does not agree with this audit finding. All consulting charges related to the transition program are allowable and reasonable. The finding argues that the portion of the consulting services related to the transition compensation program be disallowed since they believe the compensation program is unallowable. As stated in the response to the compensation program findings, HCSC believes the compensation program is allowable, therefore the consulting services are also.

Recommendation:

Based on the above, the questioned costs of $92,102 should be allowed.

Fixed Assets Overstated

HCSC does not currently dispute this finding.

Unclaimed Costs

These expenses are allowable and allocable to the contracts. They were not claimed due to HCFA imposed budget constraints. Any audit adjustments that result in reductions to allowable expenses below the NOBA amounts will be offset by these voluntary reductions to the extent the NOBA limits allow.

Recommendation:

The unclaimed costs for 1997 and 1996 should be used to offset any audit adjustments related to FYE 1997 and 1996.