DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Washington, D.C. 20201

MAR 2 8 2006

TO: Herb Kuhn
Director, Center for Medicare Management
Centers for Medicare & Medicaid Services

FROM: Joseph E. Vengrin
Deputy Inspector General for Audit Services

SUBJECT: Review of Medicare Part A and Part B Administrative Costs Claimed by Empire Medicare Services—October 1999 Through September 2002 (A-02-03-01020)

Attached is an advance copy of our final report on Medicare Part A and Part B administrative costs claimed by Empire Medicare Services (the Medicare Division) from October 1999 through September 2002. We will issue this report to the Medicare Division within 5 business days. During our audit period, the Medicare Division was a division of Empire Blue Cross and Blue Shield (Empire), a Medicare contractor for the Centers for Medicare & Medicaid Services (CMS).

Our objectives were to determine whether (1) Empire and its Medicare Division had effective internal controls, accounting systems, and reporting procedures for the administrative costs included in the cost proposals and (2) these costs were allocable, reasonable, and allowable in accordance with part 31 of the Federal Acquisition Regulations (FAR) and Appendix B of the Medicare contract.

The internal controls of Empire and its Medicare Division were largely effective in identifying costs that should be excluded from the cost proposals. Likewise, Empire's accounting systems, in general, effectively accumulated expenses to be included in the cost proposals, and Empire reported expenditures in substantial compliance with the FAR and Medicare contract provisions. However, weaknesses in certain controls—primarily those for screening indirect costs—resulted in claims for $4,686,611 (1.32 percent of the total costs) that should not have been charged to Medicare. These costs, which we are recommending for financial adjustment, included:

- $3,533,142 in unallocable costs, comprising incentive compensation (bonus) expenses ($3,054,774) and insurance and other expenses ($478,368) related solely to Empire's private lines of business, rather than to Medicare;

- $1,060,263 in inequitably allocated costs, representing excessive charges to Medicare for corporate overhead; and

- $93,206 in unallowable costs, representing executive compensation in excess of Federal limits ($58,360), as well as costs for lobbying, public relations, and corporate reorganization ($34,846).

We are also setting aside for CMS's resolution $2,090,653 in "forward funding" costs, which are not-yet-incurred expenses for which funding has been received but for which the services will extend into the subsequent fiscal year. Because these costs had not been incurred by the audit cutoff date, we did not determine whether the expenses, as subsequently incurred, were allocable, reasonable, or allowable.

We recommend that Empire:

- reduce its cost proposals by $4,686,611, consisting of $3,533,142 in unallocable costs, $1,060,263 in inequitably allocated costs, and $93,206 in unallowable costs;

- work with CMS to determine the extent to which the $2,090,653 in reported forward-funding costs are allocable, reasonable, and allowable;

- properly allocate bonuses in future cost proposals;

- develop equitable indirect cost rates for use in future cost proposals; and

- properly consider, in future cost proposals, all elements of executive compensation when calculating compensation in excess of Federal limits and exclude unallowable expenses from costs transferred to Medicare.

In its comments on our draft report, Empire concurred with our findings and recommendations, except for the finding and recommendations concerning unallocable bonus payments. Empire disagreed with our interpretations of Federal requirements regarding when bonus payments could be allocated to Medicare, our conclusions about its allocation methods, and our recommendations to reduce its cost proposal by $3,054,774 and properly allocate bonuses in future cost proposals.[1]

After reviewing applicable Federal regulations, Empire's Medicare contract with CMS, and Empire's comments on our draft report, we continue to believe that our findings and recommendations are valid.

If you have any questions or comments about this report, please do not hesitate to call me, or your staff may contact George M. Reeb, Assistant Inspector General for the Centers for Medicare & Medicaid Audits, at (410) 786-7104 or James P. Edert, Regional Inspector General for Audit Services, Region II, at (212) 264-4620. Please refer to report number A-02-03-01020.

Attachment

[1]The $3,054,774 equals our recommended adjustment of $4,686,611 less Empire's $1,631,837 concurrence on the other findings.

DEPARTMENT OF HEALTH & HUMAN SERVICES OFFICE OF INSPECTOR GENERAL

OFFICE OF AUDIT SERVICES
Region II
Jacob K. Javits Federal Building
New York, New York 10278
(212) 264-4620

MAR 30 2006

Report Number: A-02-03-01020

Mr. William Foley
Vice President, Medicare Operations
Empire Medicare Services
2651 Strang Boulevard
Yorktown Heights, New York 10598-2909

Dear Mr. Foley:

Enclosed are two copies of the U.S. Department of Health and Human Services (HHS), Office of Inspector General (OIG) final report entitled "Review of Medicare Part A and Part B Administrative Costs Claimed by Empire Medicare Services—October 1999 Through September 2002." A copy of this report will be forwarded to the HHS action official noted on the next page for review and any action deemed necessary.

The HHS action official will make final determination as to actions taken on all matters reported. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act, 5 U.S.C § 552, as amended by Public Law 104-231, OIG reports issued to the Department's grantees and contractors are made available to the public to the extent the information is not subject to exemptions in the Act that the Department chooses to exercise (see 45 CFR part 5).

Please refer to report number A-02-03-01020 in all correspondence.

Sincerely,

James P. Edert

James P. Edert
Regional Inspector General
for Audit Services

Enclosures

Direct Reply to HHS Action Official:

Mr. James T. Kerr
Regional Administrator
Centers for Medicare & Medicaid Services, Region II
26 Federal Plaza, Room 3811
New York, New York 10278

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

REVIEW OF MEDICARE PART A AND PART B ADMINISTRATIVE COSTS CLAIMED BY EMPIRE MEDICARE SERVICES—OCTOBER 1999 THROUGH SEPTEMBER 2002

**Daniel R. Levinson
Inspector General**

**MARCH 2006
A-02-03-01020**

Office of Inspector General

http://oig.hhs.gov

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OAS FINDINGS AND OPINIONS

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed, as well as other conclusions and recommendations in this report, represent the findings and opinions of the HHS/OIG/OAS. Authorized officials of the HHS divisions will make final determination on these matters.

DEPARTMENT OF HEALTH & HUMAN SERVICES · USA

EXECUTIVE SUMMARY

BACKGROUND

The Centers for Medicare & Medicaid Services (CMS) administers the Medicare program through contracts with private organizations that process and pay Medicare claims. The contracts provide for the reimbursement of administrative costs incurred in processing Medicare claims.

During the audit period, which covered fiscal years (FYs) 2000–2002, CMS contracted with Empire Blue Cross and Blue Shield (Empire) to serve as a Medicare contractor in Connecticut, Delaware, Massachusetts, New Jersey, and New York. Empire Medicare Services (the Medicare Division), a division of Empire, processed Hospital Insurance (Part A) claims and Supplemental Medical Insurance (Part B) claims and served as a regional host site for the Common Working File.[1] Empire reported Medicare costs totaling $354,012,142 in its FYs 2000–2002 Final Administrative Cost Proposals (cost proposals).

OBJECTIVES

Our objectives were to determine whether (1) Empire and its Medicare Division had effective internal controls, accounting systems, and reporting procedures for the administrative costs included in the cost proposals and (2) these costs were allocable, reasonable, and allowable in accordance with part 31 of the Federal Acquisition Regulations (FAR) and Appendix B of the Medicare contract.

SUMMARY OF FINDINGS

The internal controls of Empire and its Medicare Division were largely effective in identifying costs that should be excluded from the cost proposals. Likewise, Empire's accounting systems, in general, effectively accumulated expenses to be included in the cost proposals, and Empire reported expenditures in substantial compliance with the FAR and Medicare contract provisions. However, weaknesses in certain controls—primarily those for screening indirect costs—resulted in claims for $4,686,611 (1.32 percent of the total costs) that should not have been charged to Medicare. These costs, which we are recommending for financial adjustment, included:

- $3,533,142 in unallocable costs, comprising incentive compensation (bonus) expenses ($3,054,774) and insurance and other expenses ($478,368) related solely to Empire's private lines of business, rather than to Medicare;

- $1,060,263 in inequitably allocated costs, representing excessive charges to Medicare for corporate overhead; and

[1]Medicare contractors use the Common Working File for claims validation and benefit authorization. Article XXXII of Empire's Part B contract defined its Common Working File "host site" as a local database system with complete Medicare entitlement, utilization, and history data for use by contractors in Connecticut, Maine, Massachusetts, New Hampshire, New York, Rhode Island, and Vermont.

- $93,206 in unallowable costs, representing executive compensation in excess of Federal limits ($58,360), as well as costs for lobbying, public relations, and corporate reorganization ($34,846).

We are also setting aside for CMS's resolution $2,090,653 in "forward funding" costs, which are not-yet-incurred expenses for which funding has been received but for which the services will extend into the subsequent fiscal year. Because these costs had not been incurred by the audit cutoff date, we did not determine whether the expenses, as subsequently incurred, were allocable, reasonable, or allowable.

RECOMMENDATIONS

We recommend that Empire:

- reduce its cost proposals by $4,686,611, consisting of $3,533,142 in unallocable costs, $1,060,263 in inequitably allocated costs, and $93,206 in unallowable costs;

- work with CMS to determine the extent to which the $2,090,653 in reported forward-funding costs are allocable, reasonable, and allowable;

- properly allocate bonuses in future cost proposals;

- develop equitable indirect cost rates for use in future cost proposals; and

- properly consider, in future cost proposals, all elements of executive compensation when calculating compensation in excess of Federal limits and exclude unallowable expenses from costs transferred to Medicare.

EMPIRE'S COMMENTS

In its comments on our draft report, Empire concurred with our findings and recommendations, except for the finding and recommendations concerning unallocable bonus payments. Empire disagreed with our interpretations of Federal requirements regarding when bonus payments could be allocated to Medicare, our conclusions about its allocation methods, and our recommendations to reduce its cost proposal by $3,054,774 and properly allocate bonuses in future cost proposals.[2] The full text of Empire's comments is presented as Appendix B.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

After reviewing applicable Federal regulations, Empire's Medicare contract with CMS, and Empire's comments on our draft report, we continue to believe that our findings and recommendations are valid.

[2]The $3,054,774 equals our recommended adjustment of $4,686,611 less Empire's $1,631,837 concurrence on the other findings.

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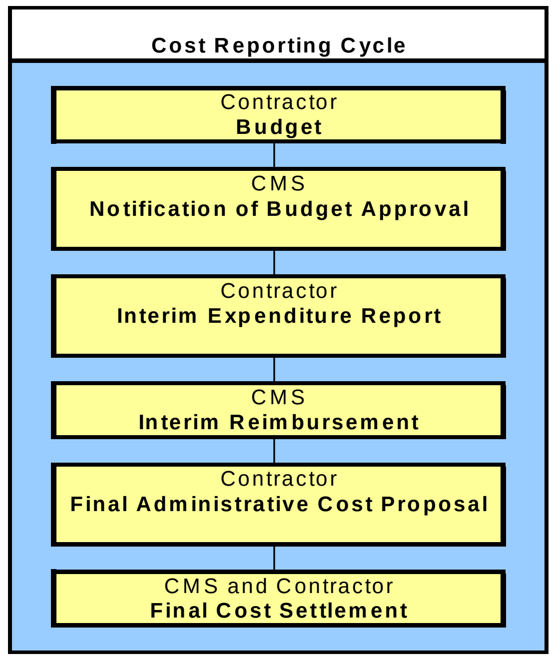
INTRODUCTION

BACKGROUND

Title XVIII of the Social Security Act established the Medicare program. The Centers for Medicare & Medicaid Services (CMS) administers the program through contracts with private organizations that process and pay Medicare claims.

CMS's contracts provide for the reimbursement of administrative costs incurred in processing Medicare claims. To claim reimbursement for these costs, contractors must first submit budgets to CMS. The major processes in the contract cycle are illustrated in the chart to the right. After the close of each fiscal year (FY), contractors submit a Final Administrative Cost Proposal (cost proposal) reporting Medicare costs. Once CMS accepts a cost proposal, the contractor and CMS negotiate a final settlement of allowable administrative costs.



During our audit period (FYs 2000–2002), CMS contracted with Empire Blue Cross and Blue Shield (Empire), the predecessor to Empire HealthChoice Assurance, Inc., to serve as a Medicare contractor in Connecticut, Delaware, Massachusetts, New Jersey, and New York.

Empire Medicare Services (the Medicare Division), a division of Empire, processed Hospital Insurance (Part A) claims and Supplemental Medical Insurance (Part B) claims and served as a regional host site for the Common Working File.[1] Empire reported Medicare costs totaling $354,012,142 in its FY 2000–2002 cost proposals.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

Our objectives were to determine whether (1) Empire and its Medicare Division had effective internal controls, accounting systems, and reporting procedures for the administrative costs included in the cost proposals and (2) these costs were allocable, reasonable, and allowable in accordance with part 31 of the Federal Acquisition Regulations (FAR) and Appendix B of the Medicare contract.

[1]Medicare contractors use the Common Working File for claims validation and benefit authorization. Article XXXII of Empire's Part B contract defined its Common Working File "host site" as a local database system with complete Medicare entitlement, utilization, and history data for use by contractors in Connecticut, Maine, Massachusetts, New Hampshire, New York, Rhode Island, and Vermont.

Scope

Our review covered the period October 1, 1999, through September 30, 2002. Because Empire changed the accounting systems used to track and claim administrative costs for Medicare reimbursement during the audit period, we gained an understanding of internal controls for both systems and analyzed the differences between them.

For FYs 2000–2002, Empire reported Medicare costs totaling $354,012,142 as of May 6, 2003, the date of the most recent cost proposal we obtained. This total included pension costs of $159,154 that we excluded from this review because they will be the subject of a separate audit. We also did not determine the allowability of actual expenditures associated with $2,090,653 of "forward funding" costs included in the cost proposals because the costs had not been incurred as of May 6, 2003. Finally, according to Empire, certain personnel records for FY 2000 could not be retrieved because they were lost on September 11, 2001. Therefore, we analyzed available records for FY 2000 in conjunction with similar complete records for FYs 2001 and 2002.

We conducted fieldwork at Empire's offices in Syracuse, Albany, and New York, NY, from May 2003 through September 2004.

Methodology

To accomplish the objectives, we:

- reviewed applicable Medicare laws, regulations, and guidelines, as well as Empire's contracts with CMS;
- reviewed the independent auditor's reports for calendar years 1999 to 2002 for weaknesses in Empire's internal control structure that could affect the allowability of administrative costs;
- reconciled the cost proposals to Empire's books and records and to the independently audited financial statements;
- performed analytical tests of Empire's trial balances;
- interviewed Empire officials about their cost accumulation processes for the cost proposals and met with CMS officials;
- gained an understanding of Empire's cost allocation systems;
- reviewed invoices, journal entries, and expense reports;
- reviewed payroll journals, corporate bonus plans, and personnel records; and
- tested costs for allocability, reasonableness, and allowability.

We conducted the audit in accordance with generally accepted government auditing standards.

FINDINGS AND RECOMMENDATIONS

The internal controls of Empire and its Medicare Division, including extensive screening and internal audit procedures, were largely successful in identifying costs that should be excluded from the cost proposals. Likewise, Empire's accounting systems, in general, effectively accumulated expenses to be included in the cost proposals, and Empire reported expenditures in substantial compliance with the FAR and Medicare contract provisions. However, weaknesses in certain control procedures—primarily those for screening indirect costs—resulted in claims for $4,686,611 (1.32 percent of the total costs) that should not have been charged to Medicare. These costs, which we are recommending for financial adjustment, include:

- $3,533,142 in unallocable costs, comprising incentive compensation (bonus) expenses ($3,054,774) and insurance and other expenses ($478,368) related only to Empire's private lines of business, rather than to Medicare;

- $1,060,263 in inequitably allocated costs, representing excessive charges allocated to Medicare for corporate overhead; and

- $93,206 in unallowable costs, representing executive compensation in excess of Federal limits ($58,360), as well as costs for lobbying, public relations, and corporate reorganization ($34,846).

We are also setting aside for CMS's resolution $2,090,653 in "forward funding" costs, which are yet-to-be-incurred expenses for which funding has been received but for which the services will extend into the subsequent fiscal year. Because these costs had not been incurred by the audit cutoff date, we did not determine whether the expenses, as subsequently incurred, were allocable, reasonable, or allowable.

UNALLOCABLE COSTS

Pursuant to FAR § 31.201-4, a cost is allocable to Medicare "if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship." Empire included $3,533,142 in its cost proposals that did not comply with this requirement.

Unallocable Bonus Payments

Empire claimed $10,251,213 in incentive bonus payments in its cost proposals for FYs 2000–2002. Of that amount, $3,054,774 was for incentive compensation costs that were not related to the Medicare program.

To be allowable, incentive compensation must meet the terms of the Medicare contract. Appendix B, reference XV, of Empire's contracts with CMS states that costs relating to non-Medicare business that do not contribute to the Medicare agreement or contract (e.g., the costs of acquiring or enrolling new subscribers) are not allowable**.**

Empire established three types of incentive compensation (bonus) plans for its employees. The Success Sharing plans awarded identical bonuses to all nonexecutives within a corporate division. The bonuses under the Annual Executive Incentive Compensation plans, on the other hand, were based both on the individual executive's performance and Empire's overall success during the year. Finally, the Long-Term Incentive plans rewarded certain executives for achievement of long-term corporate objectives. Each year, Empire identified specific corporate goals for each of the incentive compensation plans.

For all three plans, some of the incentive payments allocated to Medicare were based on goals pertaining exclusively to Empire's commercial activities rather than Medicare activities. The goals included an improved managed care profit margin, growth in managed care enrollment, managed care customer satisfaction with customer service, and successful training of employees in processing non-Medicare claims. The resultant $3,054,774 overcharge to Medicare included bonuses for both the Medicare Division and Empire's non-Medicare staff:

- Bonuses of $479,481 for Medicare Division executives, who worked on Medicare activities, pertained only to non-Medicare goals achieved by Empire's non-Medicare staff.

- Our analysis of $2,575,293 in bonuses for Empire's non-Medicare staff was limited to the bonus plans and costs because Empire declined to provide the supporting personnel records. The written objectives of the plans did not relate to the Medicare program.

We believe that Empire claimed the unallocable bonus costs because it did not properly interpret Federal cost principles and the terms of its Medicare contracts regarding the allocation of incentive payments to Medicare.

Unallocable Costs for Non-Medicare Expenses

Empire improperly included $478,368 of unallocable costs for non-Medicare expenses in its cost proposals:

- Insurance premium costs of $379,434 were not allocable to the Medicare program. Several insurance policies, including those for managed care and media liability, related exclusively to Empire's non-Medicare activities and did not benefit the Medicare program.

- Empire transferred non-Medicare costs of $98,934 to the Medicare Division. These unallocable expenses pertained solely to a commercial business venture, tax filings for Empire's managed care business line, and consultant services for developing a commercial dental insurance product that benefited only Empire's non-Medicare lines of business.

Because these expenses were not incurred specifically for the Medicare contract, did not benefit the Medicare contract, and were not necessary to Empire's overall operation, as required by FAR § 31.201-4, they were not allocable to the Medicare program.

Regarding the insurance premium costs, Empire officials stated that they included the costs in the cost proposals because they believed that the coverage benefited the Medicare program. However, the insurance premium costs related exclusively to Empire's non-Medicare lines of business. Empire did not exclude the remaining expenses from the cost proposals because its screening processes and internal audit procedures were not fully effective.

INEQUITABLY ALLOCATED COSTS

Empire claimed $27,707,428 for indirect costs in its cost proposals for FYs 2000–2002. Of this amount, $1,060,263 should not have been charged to Medicare.

FAR § 31.203(a) defines an indirect cost as ". . . any cost not directly identified with a single, final cost objective . . . . After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated to the several cost objectives."

In addition, FAR § 31.203(c) provides that ". . . an appropriate base for distributing indirect costs . . . shall not be fragmented by removing individual elements. All items properly includable in an indirect cost base should bear a pro rata share of indirect costs . . . ."

Empire calculated indirect cost rates that were intended to allocate overhead expenses to all lines of business, including Medicare. The rates were to be computed by dividing the salaries for each line of business by the total salaries for all lines of business. The rates were then to be used to allocate indirect costs to each line of business.

The rate calculations were unreasonable because the data used to calculate the rates excluded all salary expenses for several new, non-Medicare lines of business. Also, Empire did not always ensure that the calculations included all salaries associated with other non-Medicare lines of business. These non-Medicare lines of business benefited from indirect costs, such as personnel, legal, and accounting services, but were not charged for these services. Instead, costs amounting to $1,060,263 were improperly shifted from non-Medicare activities to the Medicare program.

The incorrect rate calculations occurred because Empire decided that new lines of business should not be assigned indirect costs. In addition, Empire and the Medicare Division lacked adequate internal controls to ensure that allocations of indirect costs complied with the FAR.

UNALLOWABLE COSTS

Pursuant to FAR § 31.201-2, factors to be considered in determining whether a cost is allowable include allocability, reasonableness, the terms of the Government contract, and any other limitations set forth in FAR § 31.201-1, et seq. In addition, FAR §§ 205 to 205-52 discuss circumstances under which certain types of costs are considered unallowable.

Empire's cost proposals included $93,206 that was unallowable under these requirements.

Executive Compensation in Excess of Federal Limits

Federal law (41 U.S.C. § 256) limits the total compensation that can be paid to a Medicare contractor's top five executives. Expenses in Empire's cost proposals for the compensation of its top five executives exceeded the salary limits by $58,360 because Empire excluded deferred compensation from its excess compensation adjustments.

Costs for Professional Services

Empire's cost proposals also included $34,846 in unallowable costs pertaining to lobbying activities, public relations services, and corporate reorganization, as shown in the table:

Unallowable Costs for Professional Services

Type of Cost	Amount
Lobbying	$16,032
Public relations	12,064
Corporate reorganization	6,750
Total	**$34,846**

FAR § 31.205-22(a) requires that contractors treat lobbying activity costs as unallowable. Pursuant to FAR § 31.205-1, public information and advertising costs are not allowable, except under limited circumstances that do not apply to the costs listed above. Also, FAR § 31.205-27 stipulates that the cost of planning or executing a business organization or reorganization is unallowable.

Despite Empire's screening procedures for detecting and eliminating unallowable expenses from its cost proposals, it did not detect or remove from the cost proposals the unallowable $34,846 that Empire transferred to the Medicare Division.

COSTS TO BE RESOLVED BY THE CENTERS FOR MEDICARE & MEDICAID SERVICES

Empire's FY 2002 cost proposals included $2,090,653 in forward-funding costs that had not been incurred as of May 6, 2003, the date of the most recent cost proposal obtained from CMS for this audit.

Chapter 1, section 90.9M, of the "Medicare Financial Management Manual" (the manual) defines forward-funding costs as expenses to be incurred for CMS-approved items for which funding has been received but for which (1) the services will extend into the subsequent fiscal year and (2) the costs will be redistributed to other categories as the expenses are incurred.

Chapter 2, section 130, of the manual allows contractors to submit supplemental cost proposals to report forward-funding costs for which no liability has been incurred and for which Federal funds may have been drawn, in whole or in part, at the time the cost proposal is filed. Our audit included supplemental filings accepted by CMS as of May 6, 2003.

Because the expenses had not been incurred by the audit cutoff date, we did not include them in our review, nor did we determine whether the expenses, if subsequently incurred, were allocable, reasonable, or allowable.

RECOMMENDATIONS

We recommend that Empire:

- reduce its cost proposals by $4,686,611, consisting of $3,533,142 in unallocable costs, $1,060,263 in inequitably allocated costs, and $93,206 in unallowable costs;
- work with CMS to determine the extent to which the $2,090,653 in reported forward-funding costs are allocable, reasonable, and allowable;
- properly allocate bonuses in future cost proposals;
- develop equitable indirect cost rates for use in future cost proposals; and
- properly consider, in future cost proposals, all elements of executive compensation when calculating compensation in excess of Federal limits and exclude unallowable expenses from costs transferred to Medicare.

EMPIRE'S COMMENTS

In its comments on our draft report, Empire concurred with our findings and recommendations, except for the finding and recommendations concerning unallocable bonus payments.[2]

Empire disagreed with our interpretations of Federal requirements regarding when bonus payments could be allocated to Medicare and with our conclusions about its bonus allocation methods. Specifically, Empire asserted that as long as its allocation was appropriate and its overall compensation was reasonable, the individual components of that compensation were irrelevant. Empire disagreed with our determination that it had

[2] Empire also commented that it had modified its procedures on record retention practices to address concerns cited in the "Other Matter" section.

improperly allocated to Medicare the costs of acquiring or enrolling new subscribers and with our conclusion that it had allocated to Medicare a portion of bonus payments based on the attainment of various corporate objectives. Instead, Empire asserted that the bonus payments were allocated to the lines of business that the individual employees' organizations directly or indirectly supported.

Therefore, Empire also disagreed with our recommendations to reduce its cost proposal by $3,054,774 in allocated bonus payments and properly allocate bonuses in future cost proposals.[3]

Empire officials requested additional details about the methodology used to calculate the unallocable costs for use in discussions with CMS during the cost settlement process.

The full text of Empire's comments is presented as Appendix B.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

After reviewing applicable Federal regulations, Empire's Medicare contract with CMS, and Empire's comments on our draft report, we continue to believe that our findings and recommendations are valid. Federal regulations and Empire's Medicare contract both provide that costs that do not benefit Medicare objectives are unallowable. Based on Empire's incentive plans, the allocated bonus payments are therefore not allowable.

We have provided Empire and CMS with the requested information about the methodology used to calculate the unallocable bonus costs.

OTHER MATTER: RECORD RETENTION PRACTICES

On several occasions during our audit, Empire experienced difficulty and significant delays in obtaining evidence to support the expenses in its cost proposals, especially in connection with the indirect cost rates developed to transfer costs to the cost proposals.[4] For example, Empire could not locate the original data supporting the development of the rates and instead had to recreate the data. This was a considerable effort, according to Empire officials, that resulted in significant delays.

Pursuant to FAR § 31.201-2(d), Empire must maintain records sufficient to support costs claimed. Likewise, Chapter 2, section 190.6, of the manual states that records related to costs and expenses of the Medicare agreement to which audit exceptions have been taken should be retained until the audit exceptions are settled and for a period of 3 years from the settlement date.

We believe that Empire could have minimized both its efforts and our audit delays by maintaining proper documentation to support the monthly indirect cost ratios. Empire also

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[3]The $3,054,774 equals our recommended adjustment of $4,686,611 less Empire's $1,631,837 concurrence on the other findings.

[4]This issue is unrelated to the September 11, 2001, loss of personnel records mentioned on page 2.

stated that a change in its computer software made it difficult to extract the data by the time we began our audit.

APPENDIXES

COSTS CLAIMED ON FINAL ADMINISTRATIVE COST PROPOSALS BY COST CLASSIFICATION

October 1, 1999, Through September 30, 2002

	FY 2000		FY 2001		FY 2002		
	Part A	Part B/ CWF*	Part A	Part B/ CWF*	Part A	Part B/ CWF*	Total
Salaries and wages	$18,488,177	$40,226,692	$19,617,650	$40,767,221	$21,908,656	$44,976,825	$185,985,221
Fringe benefits	4,587,398	10,819,150	4,805,980	10,562,624	5,954,322	13,263,909	49,993,383
Facilities or occupancy	2,714,631	6,920,091	3,137,265	7,482,696	3,091,993	7,021,530	30,368,206
Electronic data processing	2,777,625	6,087,764	2,826,040	5,783,708	3,110,388	6,266,923	26,852,448
Subcontracts	632,909	16,180,501	786,662	12,657,293	577,364	13,824,160	44,658,889
Outside professional services	788,788	2,113,988	1,103,685	2,781,957	1,405,290	2,555,215	10,748,923
Telephone and telegraph	436,723	1,490,734	288,268	906,076	197,869	784,436	4,104,106
Postage and express	1,884,489	4,167,687	1,934,468	4,405,866	2,010,753	4,773,235	19,176,498
Furniture and equipment	808,178	1,883,487	735,486	1,996,230	618,212	1,500,722	7,542,315
Materials and supplies	578,387	1,839,632	554,279	1,726,663	553,297	1,579,844	6,832,102
Travel	409,621	244,814	571,737	560,927	492,689	601,714	2,881,502
Return on investment	136,711	406,722	141,456	429,550	75,544	253,469	1,443,452
Miscellaneous	438,468	71,801	(77,105)	346,749	619,221	2,343,447	3,742,581
Other	-	-	-	-	-	-	-
Credits	(1,190,002)	(11,605,544)	(1,255,234)	(12,639,879)	(1,353,991)	(14,363,487)	(42,408,137)
Forward funding	-	-	-	-	225,296	1,865,357	2,090,653
Total	**$33,492,103**	**$80,847,519**	**$35,170,637**	**$77,767,681**	**$39,486,903**	**$87,247,299**	**$354,012,142**

*The CWF is the Common Working File.

MEDICARE
Part A Intermediary
Part B Carrier

William E. Foley
Vice President
Empire Medicare Services
2651 Strang Boulevard
Yorktown Heights, NY 10598

Telephone: 914-248-2852
Facsimile: 914-248-2948
Internet: william.foley@empireblue.com

January 20, 2006

Mr. James P. Edert
Regional Inspector General for Audit Services
DHHS-OIG Office of Audit Services
26 Federal Plaza
New York, N.Y. 10278

REF.: Draft Report: Review of Medicare Part A and Part B Administrative Costs Claimed by Empire Medicare Services—October 1999 through September 2002 (A-02-03-01020)

Dear Mr. Edert:

We are pleased to provide comments to the findings and recommendations presented in the draft audit report that accompanied your letter dated December 7, 2005.

Findings

1. Unallocable bonus payments

For fiscal years 2000 through 2002, we included in our cost proposals $3,054,774 of incentive compensation costs that the OIG concluded "were not related to the Medicare program." We do not agree with this finding.

We note that the OIG has accepted the allocation methodology we have used regarding the percentage of regular salaries that we have allocated to Medicare. We believe that as long as the overall allocation is appropriate, and as long as the overall compensation is reasonable, the individual components of that compensation are irrelevant.

It appears that the OIG has made an attempt to separate the incentive compensation costs that we allocated to Medicare into allowable and unallowable components. The methodology used to do this has not been explained to us, and we would want to understand this methodology.

Regardless of the rationale used, however, we believe that the full amount that we have allocated is an allowable cost.

Although the audit report cites FAR §31.201-4 as the basis for its conclusion that these costs are unallocable, pursuant to FAR §31.201-4(c), a cost is allocable if it "is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown."

Consistent with this standard, courts have determined that "it is fair to allocate to government contracts the costs of services which facilitate performance of the particular contracts or are essential to the existence and continuance of the business entity." Lockheed Aircraft Corp. v. United States, 375 F.2d 786,794 (Ct. Cl. 1967); see also, Boeing North America, Inc. v. Roche, 298 F.3d 1274, 1281 (Fed. Cir. 2002).

These incentive payments clearly are (1) "necessary to the overall operation of the business" and (2) are "essential to the existence and continuation of the business entity." Specifically, compensation packages, including the payment of incentive bonuses, are necessary to the overall operation of the highly competitive business at issue here. They are standard in the marketplace and expected by competent management executives. Failure to provide these payments would make it difficult to employ and retain highly trained and qualified personnel. Without the proper personnel in place, the overall operation of Empire's business, including its Medicare operations, would be compromised.

Based on our understanding of applicable FAR requirements, we do not believe there is a clear rationale to disallow individual components of a market-based compensation program. For example, one company may offer higher base salaries and have more generous health insurance benefits and not offer an incentive compensation program. We have chosen — again, consistent with general industry trends — to offer incentive compensation largely in lieu of normal annual increases in base pay.

And, we do not believe that incentive compensation, regardless of how the goals may have been designed, is addressed by Appendix B, Section XV, of our Medicare contract. Specifically, we do not agree that we allocated to Medicare any costs of "acquiring or enrolling new subscribers."

Finally, by way of clarification with respect to the bonuses paid to non-Medicare Division executives, we did not allocate to Medicare a percentage of the payments based on the attainment of the various corporate objectives. Rather, the amount paid to each eligible employee, like the individual's base pay, was allocated to the lines of business that the individual's organization directly or indirectly supported.

2. Unallocable insurance premium costs and other expenses

For fiscal years 2000 through 2002, we included in our cost proposals allocations of some insurance premium costs and certain other expenses that we agree were inadvertently allocated to Medicare.

3. Inequitably allocated costs

We agree that these costs were inappropriately allocated to Medicare.

4. Unallowable Costs

We agree that these costs were inadvertently allocated to Medicare.

Recommendations

- Reduce our cost proposals — We agree to reduce our cost proposals by a total of $1,631,837, representing the amounts inadvertently or inappropriately allocated to Medicare. As explained above, we do not agree to reduce our cost proposals by the allocations of incentive compensation payments totaling $3,054,774, as identified in the report.

- Work with CMS to determine the extent to which forward-funding costs are allocable, reasonable, and allowable — Following the conclusion of this audit, we will provide CMS with assurance that the agreed-upon recommendations will be applied to the forward-funded costs.

- Properly allocate bonuses in future cost proposals — We do not agree that the bonuses were improperly allocated.

- Develop equitable indirect cost rates for use in future cost proposals — We have incorporated the recommended changes into our overall allocation procedures.

- Properly consider, in future cost proposals, all elements of executive compensation when calculating compensation in excess of Federal limits — We have incorporated the recommended changes into our overall cost accounting procedures.

Other Matter — Record retention practices

Indirect cost rates were developed via systematic calculation by the Oracle Financial Analyzer cost allocation system. These rates were developed systematically due to the complex nature of the calculation. The system was relied upon to perform these complex calculations without manual intervention to ensure accurate results. We were asked to manually recreate these rates for the years under audit, which resulted in a significant work effort due to the complex nature of the calculations.

In response to this recommendation, new procedures have been implemented to validate these calculations on a monthly basis and to retain this information pursuant to the applicable requirements.

Thank you for the opportunity to provide these comments to this draft audit report.

Sincerely,

William E. Foley
Vice President

ACKNOWLEDGMENTS

This report was prepared under the direction of James P. Edert. Other principal Office of Audit Services staff who contributed include:

Elliot Hirshon, *Audit Manager*
Rafael Vargas, *Senior Auditor*
Tyeese Cavallaro, *Auditor*
Sarah Cohen, *Auditor*
Peter DiStefano, *Auditor*
Stephen Hobday, *Auditor*
Rohan Ramdeholl, *Auditor*

For information or copies of this report, please contact the Office of Inspector General's Public Affairs office at (202) 619-1343.