DEPARTMENT OF HEALTH & HUMAN SERVICES

Off Ice of Inspector General

Memorandum

Date AUG 1 3 1996

From for June Gibbs Brown
Inspector General

Subject Audit of Administrative Costs - Part A of the Medicare Program - Blue Cross of California (A-09-96-OO054)

To Bruce C. Vladeck
Administrator
Health Care Financing Administration

This memorandum is to alert you to the issuance on August 15, 1996 of our final report. A copy is attached.

This report presents the results of the certified public accounting firm's, Conrad & Associates, audit of costs claimed on Blue Cross of California's (Blue Cross) final administrative cost proposals for Part A of the Medicare program for the Fiscal Years 1991 through 1994. We have performed sufficient work to satisfy ourselves that the attached audit report can be relied upon and used by the Health Care Financing Administration in meeting its program oversight responsibilities.

We are recommending a financial adjustment of $1 ,653,079 of the costs claimed because Blue Cross:

overstated Medicare costs by $857,201 because of the inadvertent exclusion of a non-Medicare cost center from the cost base used to allocate administrative costs to Medicare;

duplicated $236,262 of costs related to a productivity investment project;

charged $233,239 of excessive executive compensation increases to Medicare;

claimed $127,996 of costs which could not be supported by underlying accounting costs records;

understated by $79,229 an adjustment of building lease costs used to limit costs claimed to the costs of ownership;

allocated $52,178 of costs incurred in cost centers which did not benefit Medicare;

overstated costs claimed by $37,431 as a result of calculation errors made during preparation of the cost reports;

claimed $28,282 of costs for which supporting documentation was not available; and

overclaimed return on investment reimbursement by $1,261 due to calculation errors.

In its response, Blue Cross questioned the appropriateness of the Employment Cost Index used to calculate the excess executive compensation and disagreed with the recommended adjustment. Blue Cross agreed with the remaining audit adjustments.

For further information, contact:

Lawrence Frelot
Regional Inspector General
for Audit Services, Region IX
(415) 437-8360

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

AUDIT OF ADMINISTRATIVE COSTS PART A OF THE MEDICARE PROGRAM BLUE CROSS OF CALIFORNIA

JUNE GIBBS BROWN
Inspector General

AUGUST 1996
A-09-96-OO054

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Region IX
Office of Audit Services
50 United Nations Plaza
San Francisco, CA 94102

August 15, 1996
CIN: A-09-96-00054

Ms. Jacqueline Anderson
General Manager, Medicare Operations
Blue Cross of California
P.O. Box 70000
Van Nuys, California 91470

Dear Ms. Anderson:

Enclosed is the report covering the audit of administrative costs incurred under the Medicare program by Blue Cross of California for the period October 1, 1990 through September 30, 1994. The audit was performed by Conrad & Associates, Certified Public Accountants, at the request of the Department of Health and Human Services (HHS), Office of Inspector General (OIG), Office of Audit Services, under contract number HHS-110-95-0023. The audit was conducted in accordance with the "Standards for Audit of Governmental Organizations, Programs, Activities and Functions," 1994 revision (GAO Standards).

Your attention is invited to the audit findings and recommendations on pages 10 through 21 of the report, which are summarized in Attachment A to our letter.

The below named Health Care Financing Administration (HCFA) official will be communicating with you in the near future regarding implementation of the recommendations. Should you have any questions or comments concerning these recommendations, please submit them to HCFA no later than 30 days from the date of this letter. If no comments are received by this date, HCFA will proceed with the initiation of the closing agreement. Your comments should be sent to:

Regional Administrator
Health Care Financing Administration
75 Hawthorne Street, 4th Floor
San Francisco, California 94105

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

To facilitate identification, please refer to the above common identification number (CIN) in all correspondence relating to this report.

Sincerely,

Lawrence Frelot
Regional Inspector General
for Audit Services

Enclosures

cc (without enclosure):
Conrad & Associates
Certified Public Accountants
1100 Main Street, Suite C
Irvine, California 92714

ATTACHMENT A
CIN: A-09-96-00054

AUDITORS' RECOMMENDATIONS

Page	Recommendations	Increase (Decrease) Amount	Code	Agency
11	The FACPs should be reduced for overstatement of Return on investment costs.	$(1,261)	001916011	HCFA
11	Require an independent review of FACPs and supporting documentation prior to submitting to HCFA.	N/A	001299101	HCFA
12	The FACPs should be reduced for calculation errors.	(37,431)	001922011	HCFA
13	The FACPs should be reduced because of allocation error.	(857,201)	001000011	HCFA
14	The FACPs should be reduced for duplicate costs claimed.	(236,262)	001906011	HCFA
15	The FACPs should be reduced for costs not allocable to Medicare.	(52,178)	001000012	HCFA
15	The FACPs should be reduced for unsupported costs claimed.	(127,996)	001900011	HCFA
16	The FACPs should be reduced for unsupported costs claimed.	(28,282)	001900012	HCFA
19	The FACPs should be reduced for excess cost of ownership costs claimed.	(79,229)	001916012	HCFA
20	The FACPs should be reduced for excess executive compensation claimed.	(233,239)	001916013	HCFA

CONRAD & ASSOCIATES, L.L.P.
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

CERTIFIED PUBLIC ACCOUNTANTS
1100 MAIN STREET, SUITE C
IRVINE, CALIFORNIA 92714
(714) 474-2020

June 12, 1996

Mr. Jerry McGee, CPA
Los Angeles Field Office
U.S. Dept. of Health and Human Services
Office of the Inspector General
Office of Audit Services
1055 Corporate Center Drive, Suite 110
Monterey Park, California 91754-7642

Dear Mr. McGee:

Enclosed please find five (5) signed copies of the final audit report regarding our Audit of Medicare Final Administrative Cost Proposals For Blue Cross of California (BCC), for the period October 1, 1990 through September 30, 1994. The reports are being submitted to you in accordance with the terms of our task order.

In addition to the final reports, please also find enclosed a copy of our Final Invoice for the audit services provided. Originals of the invoice have already been forwarded to the Division of Accounting Operations and the Division of Contract Operations for DHHS.

If you have any questions please feel free to contact me.

Yours truly,

CONRAD & ASSOCIATES, L.L.P.

Ronald E. Rolwes, CPA, CFE
Partner

RER/dc

Enclosure

BLUE CROSS OF CALIFORNIA
WOODLAND HILLS, CALIFORNIA

Audit of Medicare Final
Administrative Cost Proposals

For the Period
October 1, 1990 through September 30, 1994

CONRAD & ASSOCIATES, L.L.P.
Certified Public Accountants
1100 Main Street, Suite C
Irvine, California 92714

BLUE CROSS OF CALIFORNIA
WOODLAND HILLS, CALIFORNIA

Audit of Medicare Final
Administrative Cost Proposals

For the Period
October 1, 1990 through September 30, 1994

Table of Contents

	Page
Executive Summary	i
Acronyms	iv
Introduction and Background	1
Objectives and Scope of Audit	4
Auditor's Reports:	
Independent Auditor's Report on Medicare Final Administrative Cost Proposals	6
Independent Auditor's Report on the Internal Control Structure Based on an Audit of Claimed Costs Performed in Accordance with Government Auditing Standards	7
Independent Auditor's Report on Compliance Based on an Audit of Claimed Costs Performed in Accordance with Government Auditing Standards	9
Findings and Recommendations:	
1. Return on Investment Error	10
2. FACP Preparation Error	11
3. Intercompany Cost Allocation Error	12
4. Duplicated FACP Adjustment	13
5. Cost Centers Not Benefiting the Medicare Program	14
6. Reported Costs Not Supported by Underlying Accounting Records	15
7. Unsupported Costs	16
8. Adjustment to Limit Building Lease Costs to That of the Cost of Ownership Excluded from FACP	17
9. Excess of Executive Compensation Increases Over the ECI Allocated to Medicare	17

BLUE CROSS OF CALIFORNIA
WOODLAND HILLS, CALIFORNIA

Audit of Medicare Final
Administrative Cost Proposals

For the Period
October 1, 1990 through September 30, 1994

Table of Contents, (Continued)

	Page
Other Matters:	
Resolution of Prior Audit Findings	22
Interim Expenditure Reports	22
Data Processing Costs	22
Complementary Insurance Credits	22
Unclaimed Costs	22
Schedules:	
A. Final Administrative Cost Proposals	24
B. Audit Adjustments	25
C. Recommended Settlement Amounts	26
Appendices:	
Appendix A – Auditee's Response	

EXECUTIVE SUMMARY

BLUE CROSS OF CALIFORNIA
WOODLAND HILLS, CALIFORNIA

Audit of Medicare Final
Administrative Cost Proposals

For the Period
October 1, 1990 through September 30, 1994

Executive Summary

Conrad & Associates, L.L.P., Certified Public Accountants, under contract with the U.S. Department of Health and Human Services (DHHS), performed a financial and compliance audit of expenditures claimed by Blue Cross of California (BCC) related to administration of the Medicare Part A program. The audit covered Final Administrative Cost Proposals (FACP's) for the Medicare program submitted by BCC for the period of October 1, 1990 through September 30, 1994. Also audited were additional costs amounting to $675,787 for fiscal year (FY) 1991 (October 1, 1990 through September 30, 1991), $1,465,060 for FY 1992 (October 1, 1991 through September 30, 1992), $866,087 for FY 1993 (October 1, 1992 through September 30, 1993) and $136,509 for FY 1994 (October 1, 1993 through September 30, 1994) that were allocated to the Medicare program but not claimed on the FACP's because inclusion of those costs would cause the BCC approved administrative budget to have been exceeded.

Our audit included such tests necessary to assure that costs charged to Medicare were allowable and allocable and were provided in an economic and efficient manner. Our audit efforts tested the allowability of those administrative costs as well as their allocability to the Medicare program using the Medicare agreements, the Federal Acquisition Regulation, and appropriate cost accounting standards and generally accepted accounting standards as guiding criteria.

Results of Audit

For the period, BCC reported Medicare Part A program administrative costs of $122,275,135. Of these costs, we have questioned $1,653,079 as follows: $244,617 for FY 1991; $111,106 for FY 1992; $1,210,837 for FY 1993; and $86,519 for FY 1994. The recommended settlement amounts presented in Schedule C do not include as an offset the amounts allocated to the Program but not claimed on the FACP's for FYs 1991 through 1994. HCFA would be responsible for approving any offsets. The following is a summarization of our findings:

1. Return on Investment

   Costs of $1,261 for FY 1994 are questioned because BCC overclaimed return on investment (ROI) reimbursements. The overclaim resulted from an error made by BCC in the calculation of building depreciation and the inclusion of certain non-Medicare assets in the base used in the ROI calculation.

2. FACP Preparation Errors

   Costs of $32,513 and $4,918 for FYs 1993 and 1994, respectively, are questioned because certain cost centers were overstated due to errors made by BCC while preparing spreadsheets used in the preparation of the FACP's.

Executive Summary, (Continued)

3. Intercompany Cost Allocation Error

Costs of $857,201 for FY 1993 are questioned because an Intercompany Cost Allocation cost center was erroneously excluded from the spreadsheet used in the preparation of the FACP.

4. Duplicated FACP Adjustment

Costs of $236,262 for FY 1993 are questioned because an adjustment to include costs related to a productivity investment project were erroneously added twice during the preparation of the FACP.

5. Cost Centers Not Benefiting the Medicare Program

Costs of $48,356 and $3,822 for FYs 1992 and 1993, respectively, are questioned because the nature and activities of certain cost centers allocating costs to Medicare did not provide a benefit to the Medicare program.

6. Reported Costs Not Supported by Underlying Accounting Records

Costs of $127,996 for FY 1991 are questioned because the FACP reported costs in excess of those reflected in the underlying Medicare accounting cost records.

7. Unsupported Costs

Costs of $28,282 for FY 1991 are questioned because supporting documentation was not provided.

8. Adjustment to Limit Building Lease Costs to That of the Cost of Ownership Excluded from FACP

Costs of $79,229 for FY 1991 are questioned because a building lease cost adjustment used to limit administrative costs claimed to that of the costs of ownership was understated.

9. Excess of Executive Compensation Increases Over the ECI Allocated to Medicare

Compensation increases given to nine BCC executives during our review period were determined not to be reasonable when compared to the Employment Cost Index (ECI) developed by the United States Department of Labor for the same period. Of the excess compensation costs identified, $233,239 were allocated to Medicare and are questioned as follows: $9,110 for FY year 1991; $62,750 for FY 1992; $81,039 for FY 1993; and $80,340 for FY 1994.

Executive Summary. (Continued)

For a complete discussion of these findings, refer to the Findings and Recommendations section of this report.

Auditee's Response

A draft copy of the report was provided to BCC requesting their response to the various findings noted in the report. The responses where appropriate, have been included in the body of the report, and included in their entirety as Appendix A of the final report. BCC in their response accepted the audit results with the exception of the questioned amount of $233,239 for "Excess of Executive Compensation Increases Over The ECI Allocated to Medicare" both from the standpoint of the actual calculation and the concept of applying the ECI developed by the United States Department of Labor. Because the total amount questioned in the report ($1,653,079) was substantially less than the amount BCC did not charge to Medicare due to budget limitations ($3,143,443), BCC elected not to pursue any further effort to locate documentation that may have supported some of the questioned items.

Except for the items discussed above, we believe that BCC has established effective systems of internal control, accounting, and reporting for administrative costs claimed for reimbursement under the Medicare program.

Acronyms

BC/BSA	The Blue Cross and Blue Shield Association
BCC	Blue Cross of California
CY	Calendar Year
DHHS	U.S. Department of Health and Human Services
ECI	Employment Cost Index
FACP	Final Administrative Cost Proposal
FAR	Federal Acquisition Regulation
FY	Fiscal Year
HCFA	Health Care Financing Administration
OIG	Office of Inspector General, U.S. Department of Health and Human Services
ROI	Return on Investment

INTRODUCTION AND BACKGROUND

BLUE CROSS OF CALIFORNIA
WOODLAND HILLS, CALIFORNIA

Audit of Medicare Final Administrative Cost Proposals

For the Period
October 1, 1990 through September 30, 1994

Introduction and Background

Health Insurance for the Aged and Disabled (Medicare), Title XVIII of the Social Security Act, provides for a hospital insurance program (Part A) and a related supplementary medical insurance program (Part B) for: (i) eligible persons aged 65 and over; (ii) disabled persons under age 65 who have been entitled to Social Security or Railroad Retirement disability benefits for at least 24 consecutive months; and (iii) individuals under age 65 with chronic kidney disease who are currently insured by, or entitled to, Social Security benefits. Medicare Part A provides protection against the costs of hospital inpatient care, post-hospital extended care, and post-hospital home health care, while Medicare Part B is a voluntary program providing protection from the cost of physician services, hospital outpatient services, home health care services, and other health services.

The Medicare program is administered by the Health Care Financing Administration (HCFA), within the U.S. Department of Health and Human Services (DHHS). Title XVIII provides, however, that public or private organizations (known as "intermediaries" for Medicare Part A and "carriers" for Medicare Part B) may assist in the program's administration.

Intermediaries are organizations, primarily Blue Cross plans and commercial insurance companies, that have been nominated by provider groups or associations to process bills and make payments that are due under the Medicare program.

Carriers are organizations, primarily Blue Shield plans and commercial insurance companies, that have been selected by the Secretary, DHHS, to handle all medical claims for a designated area. Contracts are executed between the Secretary and the Blue Shield plans and commercial insurance companies that participate as Medicare carriers.

The agreements (or contracts) define the functions to be performed and provide for the reimbursement of allowable administrative costs incurred in their performance. Each participating intermediary and carrier (contractor) submits a prospective budget of administrative costs to be incurred during the Government fiscal year to the HCFA Regional Office for review and approval. Monthly expenditure reports are also submitted by the contractors reporting accrued expenditures. Following the close of each fiscal year, a final administrative cost proposal (FACP) is submitted, reporting the costs of performing Medicare functions incurred during the year. This cost proposal and supporting data serve as the basis for final settlement of allowable administrative costs.

Copies of each contractor's FACP are furnished by the HCFA Regional Offices to the appropriate Regional Office of Inspector General (OIG). After audit of the cost proposals, a final settlement is negotiated by the contractor and HCFA.

Introduction and Background. (Continued)

Contracts have been executed between HCFA and The Blue Cross and Blue Shield Association (BC/BSA) to perform services in various states as an intermediary under Part A of the Medicare program. The BC/BSA in turn subcontracted with Blue Cross of California (BCC) to serve as a Part A intermediary. BCC was required to receive, disburse, and account for funds in making payments for services furnished to eligible individuals. Other functions included making determinations as to coverage of services and reasonableness of charges, furnishing timely information and reports to HCFA, and maintaining records to ensure the correctness and verification necessary for the administration of the contracts. Detailed requirements were specified in the HCFA Intermediaries Manual which BCC was required to follow.

BCC was paid its costs for administration of the contracts under the principle of neither profit nor loss. Appendix B of the contracts and referenced federal regulations identified allowable administrative costs that could be reimbursed. Included in the administrative costs claimed for reimbursement are costs for general and administrative expenses attributable to the general management, supervision, and conduct of a contractor's business as a whole. The compensation packages of BCC's senior executives account for a substantial portion of BCC's general and administrative expenses that are allocated to the Medicare program for reimbursement. HCFA and BCC negotiated the amount of an annual budget for administrative expenses.

BCC accumulates administrative costs incurred under the Medicare program as either direct costs or indirect costs.

The Medicare Agreement states, ". . . costs allowable and allocable under this agreement shall be determined in accordance with the provisions of Part 31 of the Federal Acquisition Regulation, as interpreted and modified by Appendix B of the agreement."

Section 31.201 of the Federal Acquisition Regulation (FAR) defines the total cost of a contract as the sum of the allowable direct and indirect costs allocable to a contract, incurred or to be incurred, less any applicable credits.

The regulations also state that items of cost are allowable charges if they meet tests of reasonableness and allocability and if generally accepted accounting principles are followed.

A reasonable cost is defined as one that would be incurred by an ordinarily prudent person in the conduct of a competitive business. Further, a cost is allocable if it is assignable or chargeable to a particular cost objective in reasonable proportion to the benefits received.

Introduction and Background, (Continued)

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

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

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

This audit report details the results of our audit of the FACP's submitted by BCC to HCFA for the period October 1, 1990 through September 30, 1994.

OBJECTIVES AND SCOPE OF AUDIT

Objectives and Scope of Audit

Our audit of the FACP's submitted by BCC for the fiscal years (FYs) ended September 30, 1991, 1992, 1993 and 1994, was made in accordance with generally accepted auditing standards and the standards for financial audits contained in the Government Auditing Standards as revised in 1994 and issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the FACP's are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the FACP's. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the FACP's. We believe that our audit provides a reasonable basis for our opinion.

The U.S. Department of Health and Human Services' Audit Guide for the Review of Administrative Costs Incurred by Medicare Intermediaries and Carriers under Title XVIII of the Social Security Act (February 1991 revision) and other appropriate guidelines and instructions were used as guides in the audit.

The audit was performed to provide HCFA with sufficient data to close out the FACP's and determine if controls were adequate for administration of the Medicare program.

An entrance conference was held on November 7, 1995 with BCC and OIG officials in Woodland Hills, California. Fieldwork was performed during the period of November 7, 1995 through January 31, 1996 except for fieldwork related to Finding and Recommendation No. 9 entitled "Unreasonable Executive Compensation Allocated to Medicare" which was completed on March 21, 1996. Our audit was conducted at BCC's offices in Woodland Hills, California. An exit conference was held with BCC, HCFA and OIG representatives in Woodland Hills, California on February 14, 1996 to discuss our findings.

Administrative costs claimed for each of the periods under audit were as follows:

Fiscal year ended September 30, 1991	$ 32,527,694
Fiscal year ended September 30, 1992	29,561,600
Fiscal year ended September 30, 1993	29,483,286
Fiscal year ended September 30, 1994	30,702,555
Total	$122,275,135

The specific objectives of our audit were to:

1. Determine whether BCC had established an effective system of internal control, accounting, and reporting for administrative costs incurred under the program.

Objectives and Scope of Audit, (Continued)

2. Ascertain whether the FACP's present fairly the costs of program administration allowable in accordance with FAR, Title 48, Chapter 1, Part 31 as interpreted and modified by the Medicare agreements.

3. Ascertain whether the contractor has complied with contractual and administrative requirements governing specific items of cost.

4. Determine whether executive compensation increases charged to the Medicare program by BCC are reasonable in comparison to the increases determined by the Department of Labor, Bureau of Labor Statistics as reported by the Employment Cost Index (ECI).

   By definition, compensation for personal services refers to any remuneration, in whatever form, for services rendered by employees. It includes, but is not limited to, salaries, wages, bonuses, incentive awards, staff benefits, contributions to pension/annuity plans, location allowances, hardship pay, and cost-of-living differential.

5. Identify the underlying causes of significant errors or problems noted and make recommendations for improvement or adjustment of costs claimed as appropriate.

As prescribed by the OIG audit guide used for this review, our examination did not include a review of the contractor's pension segmentation.

To meet the above stated objectives, our audit included a study of those internal control procedures of BCC to the extent we considered necessary to evaluate the system and determine specific compliance therewith. In addition, we performed tests of specific costs to determine that BCC has complied with contractual and administrative requirements. All significant items noted during our audit are discussed in the Findings and Recommendations section of this report. Our Independent Auditor's Report on Internal Control Structure Based on an Audit of Claimed Costs Performed in Accordance with Government Auditing Standards and our Independent Auditor's Report on Compliance Based on an Audit of Claimed Costs Performed in Accordance with Government Auditing Standards are included in the Auditor's Reports section of this report.

During our audit we used judgmental sampling techniques for the purpose of determining the audit sample sizes. Our samples were designed to be representative and adequate for the purposes of expressing an opinion on the FACP's and included tests of wages, non-personnel costs, cost allocation policies and procedures, as well as specific tests for unallowable costs. Findings included in this report have been based solely upon our sample results.

AUDITOR'S REPORTS

CONRAD & ASSOCIATES, L.L.P.
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

CERTIFIED PUBLIC ACCOUNTANTS
1100 MAIN STREET, SUITE C
IRVINE, CALIFORNIA 92714
(714) 474-2020

U.S. Department of Health and Human Services
Health Care Financing Administration

INDEPENDENT AUDITOR'S REPORT ON MEDICARE FINAL ADMINISTRATIVE COST PROPOSALS

We have audited the Final Administrative Cost Proposals of Blue Cross of California (BCC) for the fiscal years ended September 30, 1991, 1992, 1993 and 1994, respectively. The amounts reported in the Final Administrative Cost Proposals are the responsibility of BCC management. Our responsibility is to express an opinion on the Final Administrative Cost Proposals based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards for financial audits contained in the Government Auditing Standards as revised in 1994 and issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Final Administrative Cost Proposals are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts claimed in the Final Administrative Cost Proposals. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Final Administrative Cost Proposals. We believe that our audit provides a reasonable basis for our opinion.

The accompanying Schedules were prepared in accordance with the instructions of the U.S. Department of Health and Human Services and reflect only administrative costs reported for the operation of the Medicare, Part A program. Accordingly, the accompanying Schedules are not intended to present financial position or results of operations in conformity with generally accepted accounting principles.

In our opinion, subject to the ultimate resolution of the $1,653,079 of questioned costs identified in this report, the Final Administrative Cost Proposals present fairly the costs of allowable program administration for the fiscal years ended September 30, 1991, 1992, 1993 and 1994, respectively, in accordance with the Federal Acquisition Regulation, Title 48, Chapter 1, Part 31, as interpreted and modified by the Medicare agreements.

This report is intended for use in connection with the administration of the Medicare contracts to which it refers. However, this report is a matter of public record, and its distribution is not limited.

Conrad & Associates L.L.P.

January 31, 1996

MEMBERS OF AICPA AND CALIFORNIA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
MEMBER OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS PRIVATE COMPANIES PRACTICE SECTION

CONRAD & ASSOCIATES, L.L.P.
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

CERTIFIED PUBLIC ACCOUNTANTS
1100 MAIN STREET, SUITE C
IRVINE, CALIFORNIA 92714
(714) 474-2020

U.S. Department of Health and Human Services
Health Care Financing Administration

INDEPENDENT AUDITOR'S REPORT ON THE INTERNAL CONTROL STRUCTURE BASED ON AN AUDIT OF CLAIMED COSTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

We have audited the Final Administrative Cost Proposals of Blue Cross of California (BCC) for the fiscal years ended September 30, 1991, 1992, 1993 and 1994, and have issued our report thereon dated January 31, 1996.

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

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

In planning and performing our audit of the Final Administrative Cost Proposals of BCC for the fiscal years ended September 30, 1991, 1992, 1993 and 1994, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the Final Administrative Cost Proposals and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

MEMBERS OF AICPA AND CALIFORNIA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
MEMBER OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS PRIVATE COMPANIES PRACTICE SECTION

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

The reportable condition noted involves the preparation of the Final Administration Cost Proposals. BCC's system for this procedure did not provide an adequate review of the schedules and adjustments used in the preparation of the Final Administrative Cost Proposals by someone other than the Final Administrative Cost Proposal preparer prior to submitting the Final Administrative Cost Proposals to HCFA.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the Final Administrative Cost Proposals being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe the reportable condition described above is not a material weakness.

This report is intended for use in connection with the administration of the Medicare contracts to which it refers. However, this report is a matter of public record, and its distribution is not limited.

Conrad & Associates L.L.P.

January 31, 1996

CONRAD & ASSOCIATES, L.L.P.
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

CERTIFIED PUBLIC ACCOUNTANTS
1100 MAIN STREET, SUITE C
IRVINE, CALIFORNIA 92714
(714) 474-2020

U.S. Department of Health and Human Services
Health Care Financing Administration

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE BASED ON AN AUDIT OF CLAIMED COSTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

We have audited the Final Administrative Cost Proposals of Blue Cross of California (BCC) for the fiscal years ended September 30, 1991, 1992, 1993 and 1994, and have issued our report thereon dated January 31, 1996.

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

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

The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

This report is intended for use in connection with the administration of the Medicare contracts to which it refers. However, this report is a matter of public record, and its distribution is not limited.

Conrad & Associates L.L.P.

January 31, 1996

MEMBERS OF AICPA AND CALIFORNIA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
MEMBER OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS PRIVATE COMPANIES PRACTICE SECTION

FINDINGS AND RECOMMENDATIONS

Findings and Recommendations

We have examined BCC's administrative costs resulting from its performance under its Medicare agreement.

The costs audited were those reported on the intermediary's FACP's for FYs 1991, 1992, 1993 and 1994, which amounted to $122,275,135 (see Schedule A).

Our audit included such tests necessary to assure that costs charged to the Medicare program were allowable and allocable and were provided in an economic and efficient manner. Our audit efforts tested the allowability of those administrative costs as well as their allocability to the Medicare program using the Medicare agreements, the FAR, and appropriate cost accounting standards and generally accepted accounting standards as guiding criteria.

The results of our review were presented to appropriate DHHS and BCC officials in the form of a draft audit report. BCC's response to that report has been included as Appendix A to this report.

The specific exceptions and corresponding recommended adjustments and corrective actions resulting from our audit of BCC's FACP's amounted to $1,653,079. Details of our findings and recommendations are as follows:

1. Return on Investment Error

   BCC included a total of $222,312 as return on investment (ROI) charges in the 1994 FACP. A revised worksheet developed by BCC for the calculation of ROI showed that only $221,051 should have been charged. The $1,261 overclaim resulted from an error in calculating building depreciation and the inclusion of certain non-Medicare assets in the valuation of furniture and equipment used in the original ROI calculation. These errors resulted in overcharges of $444 related to space costs and $817 related to furniture and equipment costs.

   The details of the two issues follow:

   a. Error on Building Depreciation

      BCC's calculation of depreciation for building and building improvements was inadvertently understated due to the use of an incorrect formula in the spreadsheet used. This understatement of depreciation increased the average undepreciated balance of building and land assets used in the ROI calculation which resulted in an overcharge of $444 in the ROI calculation.

Findings and Recommendations, (Continued)

1. Return on Investment Error, (Continued)

b. Error in the Valuation of Furniture and Equipment

BCC's valuation of furniture and equipment was overstated by $1,200,000. The overstatement of furniture and equipment assets was due to the inclusion of WellPoint Health Networks, Inc. ("WellPoint") assets. The Medicare program did not utilize assets from WellPoint (a BCC subsidiary) and therefore, the assets of WellPoint should not be included in the ROI calculation. The overstatement of furniture and equipment assets resulted in an overcharge of $817 in the ROI calculation.

A summary of the ROI overcharges is as follows:

ROI Calculation	Claimed ROI	Revised ROI	Difference
Depreciation	$150,409	149,965	444
Furniture and equipment	71,903	71,086	817
Totals	$222,312	221,051	1,261

Recommendation

We recommend that the FACP be decreased by $1,261 for FY 1994. In addition, we recommend that an employee other than the preparer of the FACP review all supporting schedules and adjustments used in the preparation of the FACP prior to submitting it to HCFA.

Auditee Response

Since the total amount of the costs questioned in the report ($1,653,079) was substantially less than the amount BCC did not charge to the Medicare program because of budget limitations ($3,143,443), BCC in their response to the draft report finding elected not to respond specifically to the questioned costs identified in this finding.

Auditor Comment

Our finding and recommendation remain as previously stated.

2. FACP Preparation Error

BCC prepares its FACP's by summarizing costs from their Medicare line of business reports. BCC summarizes the Medicare costs monthly on a Lotus-type spreadsheet so that costs are accumulated on a Medicare fiscal year basis. (BCC internal records are maintained on a calendar year basis).

Findings and Recommendations, (Continued)

2. FACP Preparation Error, (Continued)

We traced the costs from the line of business reports to the spreadsheet for each month and noted that errors occurred in the recording of Cost Center 7010641 in FY 1993 and Cost Center 40480007 in FY 1994. The errors noted resulted in Medicare costs being overclaimed by $32,513 and $4,918 for FYs 1993 and 1994, respectively. The errors appear to be the result of no one other than the FACP preparer reviewing the various subsidiary schedules used in the preparation of the FACP prior to its submission to HCFA.

Recommendation

We recommend that the FACP be decreased by $32,513 and $4,918 for FYs 1993 and 1994, respectively. In addition, we recommend that an employee other than the preparer of the FACP review schedules used in the preparation of the FACP's prior to submitting them to HCFA.

Auditee Response

Since the total amount of the costs questioned in the report ($1,653,079) was substantially less than the amount BCC did not charge to the Medicare program because of budget limitations ($3,143,443), BCC in their response to the draft report finding elected not to respond specifically to the questioned costs identified in this finding.

Auditor Comment

Our finding and recommendation remain as previously stated.

3. Intercompany Cost Allocation Error

During FY 1993, BCC overstated program costs by $857,201 because of the inadvertent exclusion of Cost Center 31090009 (Corporate Development – Cost Allocation). The inclusion of this cost center is necessary in the preparation of the FACP in order to offset other intercompany allocation cost centers included in the FACP.

The FACP is the result of program costs incurred, net of various "below the line" cost adjustments. During the audit period, BCC excluded certain cost centers from the FACP. The total of these excluded cost centers is referred to as "Schedule A" cost adjustments. In FY 1993, BCC included its intercompany cost allocation centers within the Schedule A adjustments. BCC intended to make the necessary adjustments to close the respective cost centers. However, Cost Center 31090009 was excluded from the Schedule A adjustments which resulted in a Medicare administrative cost overclaim of $857,201.

Findings and Recommendations, (Continued)

3. Intercompany Cost Allocation Error, (Continued)

BCC inadvertently excluded the cost center from its Schedule A adjustments apparently because of the misleading title given to the cost center. The cost center was titled "Corporate Development–Cost Allocation" as opposed to the more generic names shown below for the other intercompany allocation cost centers.

Cost Center	Cost Center Number	Balance at 9-30-93	Adjustment	Adjusted Balance at 9-30-93
BCC Interco Cost Allocation	10090009	$(870,768)	870,768	-
Group Interco Cost Allocation	30490009	10,883	(10,883)	-
GSC Interco Cost Allocation	30690009	2,684	(2,684)	-
Corp Dev. Cost Allocation	31090009	857,201	-	857,201
		$ -	857,201	857,201

Recommendation

We recommend that the FACP be decreased by $857,201 for FY 1993. In addition, we recommend that an employee other than the preparer of the FACP review all supporting schedules used in the preparation of the FACP prior to submitting it to HCFA.

Auditee Response

We are concerned that an error of this magnitude occurred and will enhance the FACP review process as recommended. During preparation of the FY 1993 FACP, the preparer went on medical leave causing the person who would have reviewed the FACP to have to complete the preparation in a limited time frame in order to meet the deadline.

Auditor Comment

Notwithstanding the auditee's response, our finding and recommendation remain as previously stated.

4. Duplicated FACP Adjustment

During FY 1993, BCC overstated Medicare costs by $236,262 due to an error in the preparation of the FACP.

During the preparation of the 1993 FACP, BCC increased Medicare costs claimed with a "below the line" adjustment of $236,262. This adjustment related to costs of an investment project performed by BCC for HCFA. While performing our audit procedures, we noted that the adjustment was erroneously included twice on the supporting schedules.

Findings and Recommendations, (Continued)

4. Duplicated FACP Adjustment (Continued)

The duplicate adjustment resulted in an overcharge of $236,262 to the Medicare program.

Recommendation

We recommend that the FACP for FY 1993 be reduced by $236,262 to compensate for the duplicate adjustment. In addition, we recommend that an employee other than the preparer of the FACP review all supporting schedules and adjustments used in the preparation of the FACP prior to submitting it to HCFA.

Auditee Response

We are concerned that an error of this magnitude occurred and will enhance the FACP review process as recommended. During preparation of the FY 1993 FACP, the preparer went on medical leave causing the person who would have reviewed the FACP to have to complete the preparation in a limited time frame in order to meet the deadline.

Auditor Comment

Notwithstanding the auditee's response, our finding and recommendation remains as previously stated.

5. Cost Centers Not Benefiting the Medicare Program

Costs of $48,356 and $3,822 for FYs 1992 and 1993, respectively, are questioned because the nature and purpose of the cost centers did not benefit the Medicare program.

During our audit of costs claimed, we noted that Cost Center 40540001 "Corporate Legal/Knox-Keene" allocated costs of $47,558 to Medicare on the 1992 FACP.

On January 7, 1993, BCC was licensed by the California Department of Corporations which regulates California health maintenance organizations under the Knox-Keene Act. WellPoint Health Networks, Inc. ("WellPoint") is a majority-owned and controlled for-profit subsidiary established in 1992 to own and operate most of BCC's managed health care business. Effective February 1, 1993, BCC transferred substantially all of the managed health care products and certain ancillary products to WellPoint and received an ownership interest in WellPoint. BCC had been regulated previously by the California Department of Insurance.

The legal costs incurred related to the change in BCC's licensure. We believe the purpose of the legal costs provided no benefit to the Medicare program and therefore, the costs were not allocable.

Findings and Recommendations, (Continued)

5. Cost Centers Not Benefiting the Medicare Program (Continued)

In addition, we noted that Cost Center 40490517 "Consumer Health Advocate" allocated $4,620 ($3,822 in FY 1993 and $798 in FY 1992) to Medicare. In discussions with BCC staff regarding the nature and purpose of the cost center, it was agreed that the costs incurred were not incurred for the benefit of the Medicare program and should not have been claimed on the FACP.

Recommendation

We recommend that the FACP's for FYs 1992 and 1993 be reduced by $48,356 and $3,822, respectively. In addition, we recommend that an employee other than the preparer of the FACP review all supporting schedules and adjustments used in the preparation of the FACP prior to submitting it to HCFA.

Auditee Response

Since the total amount of the costs questioned in the report ($1,653,079) was substantially less than the amount BCC did not charge to the Medicare program because of budget limitations ($3,143,443), BCC in their response to the draft report finding elected not to specifically respond to the questioned costs identified in this finding.

Auditor Comment

Our finding and recommendation remain as previously stated.

6. Reported Costs Not Supported by Underlying Accounting Records

Costs of $127,996 for FY 1991 are questioned because the FACP reported costs in excess of amounts reflected in the underlying accounting records.

During FY 1991, the FACP was comprised of costs reported in the Medicare Line of Business Reports and the Shared Services Reports. During our reconciliation of the costs reported on the FACP to the costs reflected in these reports, we noted that adjustments increasing costs reflected in the Shared Services Reports by $127,996 were not supported. Current BCC staff were unable to determine the nature or reason for the adjustment.

As a result, costs reported and claimed on the FY 1991 FACP were overstated by $127,996.

Recommendation

We recommend that BCC exclude unsupported costs of $127,996 from its FY 1991 FACP. In addition, we recommend that an employee other than the preparer of the FACP review all supporting schedules and adjustments used in the preparation of the FACP prior to submitting it to HCFA.

Findings and Recommendations, (Continued)

6. Reported Costs Not Supported by Underlying Accounting Records, (Continued)

Auditee Response

We believe these records were in existence and have been misplaced due to organizational and location changes between 1992 and the time of the audit, late 1995. As the costs not claimed exceed the amount questioned, we believe further research would not be cost effective.

Auditor Comment

Notwithstanding the auditee's response, our finding and recommendation remains as previously stated.

7. Unsupported Costs

Costs of $28,282 in FY 1991 are questioned because supporting documentation was not provided.

We selected various costs claimed for testing and requested supporting documentation in order to determine if the costs were reasonable, allowable and allocable to the Medicare contract. BCC personnel indicated support for the items requested could not be found.

As a result, $28,282 of costs claimed are questioned as unsupported costs. Total questioned costs are as follows:

Cost Classification	FY 1991
Consulting services	$27,000
Employee reimbursement	1,282
Total	$28,282

Recommendation

We recommend that BCC reduce its FACP for FY 1991 by $28,282 for costs claimed which were unsupported.

Auditee Response

We believe these records were in existence and have been misplaced due to organizational and location changes between 1992 and the time of the audit, late 1995. As the costs not claimed exceed the amount questioned, we believe further research would not be cost effective.

Auditor Comment

Notwithstanding the auditees' response, our finding and recommendation remains as previuosly stated.

Findings and Recommendations, (Continued)

8. Adjustment to Limit Building Lease Costs to That of the Cost of Ownership Excluded from FACP

Costs of $79,229 for FY 1991 are questioned because the adjustment to reduce space cost claimed to the cost of ownership was understated.

BCC records space cost according to their lease agreement. However, since BCC's space cost is the result of a sale/leaseback transaction, BCC can only charge Medicare for the costs of ownership. Since BCC's lease costs are significantly higher than the costs of ownership, an adjustment to reduce space cost down to the cost of ownership is required each fiscal year.

In FY 1991, BCC estimated the space cost adjustment at $301,135 when preparing its initial FACP. Worksheets reflecting the final computation of ownership costs showed that an adjustment of $380,364 was required. However, the required additional adjustment was not made and as a result the FY 1991 FACP was overstated by $79,229.

Recommendation

We recommend that BCC reduce the costs claimed on the FY 1991 FACP by $79,229. In addition, we recommend that an employee other than the preparer of the FACP review all supporting schedules and adjustments used in the preparation of the FACP prior to submitting it to HCFA.

Auditee Response

Since the total amount of the costs questioned in the report ($1,653,079) was substantially less than the amount BCC did not charge to the Medicare program because of budget limitations ($3,143,443), BCC in their response to the draft report findings elected not to specifically respond to the questioned costs identified in this finding.

Auditor Comment

Our finding and recommendtion remains as previously stated.

9. Excess of Executive Compensation Increases Over the ECI Allocated to Medicare

As noted in the Objectives and Scope of Audit section of this report, one of our objectives was to determine whether increases to the compensation packages of executives of BCC were reasonable, and if not, the effect of unreasonable increases on the Medicare program. Our review was limited to compensation increases received during calendar years (CY) 1991 through 1994 to higher paid executives of BCC who were charged to Medicare.

Findings and Recommendations, (Continued)

9. Excess of Executive Compensation Increases Over the ECI Allocated to Medicare (Continued)

From information provided by BCC, we determined the compensation package of top paid executives for each of the four years under review. Not all of the executives were employed by BCC for the entire four-year period of our review. In addition, not all of the executives had a portion of their salaries allocated to the Medicare program over the entire four-year period. Therefore, in computing increases in compensation we used as the base year either the executive's actual compensation package for CY 1990, or their compensation package for a later year if not employed or allocated to Medicare in CY 1990. We used as the final year of our review either the compensation package for CY 1994, or the package for the year in which the executive was terminated, or no longer allocated to Medicare, if prior to CY 1994. We did not attempt to determine the reasonableness of the base year compensation packages.

We used the Employment Cost Index (ECI) which is developed and published by the United States Department of Labor, Bureau of Labor Statistics to determine a reasonable rate of compensation increase. The ECI measures the rate of change in compensation and includes wages, salaries, and employers cost of employee benefits. The ECI uses a fixed market basket of labor – similar in concept to the Consumer Price Index's fixed market of goods and services – to measure change over time in employer costs of employing labor.

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

The ECI is published each quarter for each industry and occupational group. In computing the ECI for executives at BCC, we used the ECI for private industry workers in the executive and managerial group. For the period January 1, 1991 through December 31, 1994, the ECI percentage increase in compensation for executive and managerial employees employed in the private sector rose a combined 13.60 percent.

Findings and Recommendations, (Continued)

9. Excess of Executive Compensation Increases Over the ECI Allocated to Medicare, (Continued)

We compared the actual annual increases received by the executives to the ECI increases for each of the four years reviewed, and noted any excess. We then computed the effect of the excess compensation on the Medicare program using the same cost methodology as used by the Medicare contractor. We must point out, however, that although we followed the same allocation method used by BCC, we recognize that BCC also made adjustments to reduce the allocated costs claimed at the beginning and end of each year to "cap" costs in order to lower the cost per claim reported on the FACP. As a result of this practice, some costs, although allocated to Medicare, may not have been charged to the Medicare program. All of these uncharged costs cannot be specifically identified.

In addition, it should be pointed out that although our analysis was done on a calendar year basis, the excess executive compensation costs allocated to the Medicare program and identified as a result of the application of our procedures have been reported and questioned on a Medicare fiscal year basis.

BCC executives with a total annual compensation over $100,000 as reported on their W-2's during CYs 1990 through 1994, where some or all of that compensation was charged either directly or indirectly to Medicare, was used as the basis to identify the higher paid executives to be included in our review. It was agreed, in the interest of efficiency, that we would only review those executives for whom the charge to Medicare exceeded 15 percent or $15,000 of their W-2 income for the years reviewed. Based on this selection criteria, the compensation increases of nine executives were reviewed for reasonableness when compared to the ECI.

During the four-year period of our review, the average annual compensation of the nine executives included in our review rose from $202,172 in the respective base years of the executives included in our review to an average of $252,663 in the final year included in our review, an increase of 24.97 percent. This increase was 11.37 percent higher than the ECI for the same period. The increases exceeded the ECI by $1,469,134 of which $233,239 was allocated to the Medicare program as follows:

Calendar Year	Compensation Increases in Excess of ECI
1991	$ 9,110
1992	62,750
1993	81,039
1994	80,340
Total	$233,239

Findings and Recommendations, (Continued)

9. Excess of Executive Compensation Increases Over the ECI Allocated to Medicare, (Continued)

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

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

The onus, therefore, is placed on BCC to show that compensation increases are reasonable. However, the increases in executive compensation awarded during CY's 1991 through 1994 when compared to the ECI for the same period show that the increases in compensation were not reasonable.

Recommendation

We recommend that the FACP's for FYs 1991 through 1994 be reduced by $233,239 ($9,110 for FY 1991; $62,750 for FY 1992; $81,039 for FY 1993; and $80,340 for FY 1994), unless BCC can demonstrate to HCFA that executive compensation increases greater than the ECI were reasonable.

Auditee Response

We are not sufficiently familiar with the underlying principles behind the ECI compilation to provide comments on the appropriateness of its application to the situation in which it is being applied. We do believe that its application to a carefully developed performance driven bonus program is questionable. The bonus program is driven by Company, organization, and individual performance factors that vary from year to year and bear no resemblance to our limited understanding of the ECI. Further, regular pay compensation increases for all employees are driven by documented review of performance giving due consideration for both internal and external factors. Sometimes higher increases are due to the assumption of additional responsibilities.

Findings and Recommendations, (Continued)

9. Excess of Executive Compensation Increases Over the ECI Allocated to Medicare, (Continued)

Auditee Response (Continued)

Bonuses are accrued in the year earned, but are paid usually in March of the following year when the performance indicators on which they are based have been compiled. The bonus paid in the year after an employee's start date is prorated according to the time of service in that (prior) year. Therefore, two of the executives in the computation of excess increases over ECI were paid prorated bonuses in the 'base' year used for the calculation of the excess. Furthermore, payout should not be prorated in the year in which an executive leaves the Company because that bonus applies to performance in the prior year and was accrued in that prior year.

An anomaly arose in 1994 whereby two employees included in the calculation availed themselves of the company's offer to buy down vacation pay in 1994 to help fund their earthquake damage. This had some distortionary effect on the apparent increases in 1994 over 1993.

Because allocable costs not claimed exceed questioned costs and because we question the appropriateness of using the ECI in this context, we are not submitting proposed revisions to the calculation. Furthermore, it would be most time consuming to research the rationale for individual pay increases in each of the years 1991 through 1994. However, we request that the audit report identify the contractual requirement to conform with increases in remuneration from year to year as "determined by the Department of Labor, Bureau of Labor Statistics as reported by the Employment Cost Index (ECI)".

Auditor Comment

The use of the ECI as a benchmark for the determination of what constituted a "reasonable" rate of compensation increase for the BCC executives subjected to our review, was specified in the audit program prepared by the OIG for use during this engagement. Although neither the Medicare agreement nor the FAR makes specific reference to the ECI as the barometer for the determination of reasonableness, the ECI nonetheless represents a valid measurement basis.

Other Matters

1. Resolution of Prior Audit Findings

A prior examination of BCC was performed by Alexander Gedrich & Company covering the period October 1, 1989 through September 30, 1990.

All findings identified in the prior audit have been resolved.

2. Interim Expenditure Reports

As part of our audit, we performed a limited review of BCC's Interim Expenditure Reports. Our review was limited to a review of methods and procedures followed by BCC in developing expenditure reports.

Except for the underlying causes of the questioned costs identified in this report, our tests disclosed that the methods and procedures used to report Medicare administrative costs on the Interim Expenditure Reports were adequate.

3. Data Processing Costs

BCC did not incur any significant costs for planning, development or modification of the Medicare claims processing system during the audit period.

4. Complementary Insurance Credits

BCC reported credits on the FACP's for FYs 1991, 1992, 1993 and 1994, which related to complementary insurance information furnished to their own complementary insurance program. As part of our audit, we performed tests on the reported complementary insurance credits and ascertained that adequate procedures were being followed to ensure compliance with the Medicare contract.

5. Unclaimed Costs

We have examined BCC's administrative costs resulting from its performance under the Medicare agreement. Those costs included amounts claimed on the Intermediary's FACP's for FYs 1991 through 1994, as well as costs allocated to the program but not included in the FACP because of budget limitations. HCFA may consider these costs when making the final settlement. The breakdown of costs not claimed by fiscal year follows:

Other Matters, (Continued)

5. Unclaimed Costs, (Continued)

Fiscal Year	Total
1991	$ 675,787
1992	1,465,060
1993	866,087
1994	136,509
Total	$3,143,443

SCHEDULES

BLUE CROSS OF CALIFORNIA
WOODLAND HILLS, CALIFORNIA

Schedule of Final Administrative Cost Proposals

Category	1994	1993	1992	1991	Total
Salaries and wages	$17,129,996	16,280,743	14,792,431	18,635,798	66,838,968
Pension costs	614,010	767,353	474,458	505,386	2,361,207
Other fringe benefits	4,502,742	3,905,502	4,904,425	4,448,434	17,761,103
Facilities and occupancy costs	836,874	879,727	1,256,504	1,646,999	4,620,104
EDP equipment	1,632,857	2,383,247	1,384,299	1,296,123	6,696,526
Outside professional services	1,402,646	779,305	1,509,800	1,173,274	4,865,025
Telephone and telegraph	726,534	302,798	1,131,214	1,026,442	3,186,988
Postage	1,311,940	1,287,223	1,399,610	1,123,732	5,122,505
Furniture and equipment	417,490	469,662	616,094	471,330	1,974,576
Materials and supplies	609,017	662,556	642,949	787,085	2,701,607
Travel	556,901	542,864	432,337	475,921	2,008,023
Return on investment	222,312	412,655	459,955	397,879	1,492,801
Miscellaneous	870,670	931,462	280,713	182,581	2,265,426
Other	-	-	358,343	281,735	640,078
Credits	(131,434)	(121,811)	(81,532)	74,975	(259,802)
Totals	$30,702,555	29,483,286	29,561,600	32,527,694	122,275,135

BLUE CROSS OF CALIFORNIA
WOODLAND HILLS, CALIFORNIA

Schedule of Audit Adjustments

Finding No.	Audit Adjustments	1994	1993	1992	1991	Total
1.	Return on Investment Error	$(1,261)	-	-	-	(1,261)
2.	FACP Preparation Errors	(4,918)	(32,513)	-	-	(37,431)
3.	Intercompany Cost Allocation Error	-	(857,201)	-	-	(857,201)
4.	Duplicated FACP Adjustment	-	(236,262)	-	-	(236,262)
5.	Cost Centers not Benefiting the Medicare Program	-	(3,822)	(48,356)	-	(52,178)
6.	Reported Costs not Supported by Underlying Accounting Records	-	-	-	(127,996)	(127,996)
7.	Unsupported Costs	-	-	-	(28,282)	(28,282)
8.	Space Cost Adjustment Excluded from FACP	-	-	-	(79,229)	(79,229)
9.	Unreasonable Executive Compensation Allocated to Medicare	(80,340)	(81,039)	(62,750)	(9,110)	(233,239)
	Total Audit Adjustments	$(86,519)	(1,210,837)	(111,106)	(244,617)	(1,653,079)

BLUE CROSS OF CALIFORNIA
WOODLAND HILLS, CALIFORNIA

Schedule of Recommended Settlements on
Final Administrative Cost Proposals

	1994	1993	1992	1991	Total
FACP Totals (Schedule A)	$30,702,555	29,483,286	29,561,600	32,527,694	122,275,135
Total Audit Adjustments (Schedule B)	(86,519)	(1,210,837)	(111,106)	(244,617)	(1,653,079)
Recommended Settlement Amounts (see Note 1)	$30,616,036	28,272,449	29,450,494	32,283,077	120,622,056

Note 1: The recommended settlement amounts shown do not consider amounts that were allocated to the Medicare program but not included on the FACP's because of budget limitations. The unclaimed amounts were included in the scope of our audit work and may be considered by HCFA when making the final settlement. Unclaimed Medicare program costs by fiscal year were as follows:

Fiscal Year	Total
1991	$ 675,787
1992	1,465,060
1993	866,087
1994	136,509
Total	$3,143,443

APPENDIX A

AUDITEE'S RESPONSE

Blue Cross
of California

Michael J. Lohnberg
Vice President
Corporate Auditor

21555 Oxnard Street
Woodland Hills, California 91367
(818) 703-3212

May 7, 1996

Mr. Ron Rolwes, CPA
Partner
Conrad and Associates
1100 Main Street
Irvine, California 92714

Dear Mr. Rolwes:

MEDICARE PART A ADMINISTRATIVE COST AUDIT
OCTOBER 1, 1991, THROUGH SEPTEMBER 30, 1994

Reference is to the draft audit report submitted to us under cover of your letter dated April 10, 1996. The audit report is questioning $1,653,079 of the claimed administrative costs of $122,275,135 for the four (4) years or 1.35%. In addition, the report states that Blue Cross of California incurred a further $3,143,443 to administer the Medicare program which was not charged or claimed due to budget limitations. As outlined below, we accept the audit results with the exception of the questioned amount of $233,239 for "excess of Executive Compensation increases over the ECI allocated to Medicare" both from the standpoint of the actual calculation and the concept of applying the Employment Cost Index (ECI) developed by the United States Department of Labor. Because the amount questioned ($1,653,079) is substantially less than the amount Blue Cross of California did not charge to Medicare due to budget limitations ($3,143,443), we have not pursued any further effort to locate documentation that may support some of the questioned items.

Below are our comments on the Findings and Recommendations in the order in which they appear in the draft audit report.

	Amount Questioned
Return on Investment (page 10)	$ 1,261
FACP Preparation Errors (pages 11/12)	37,431
InterCompany Cost Allocation (pages 12/13) (see 1 below)	857,201
Duplicated FACP Adjustment (page 13) (see 1 below)	236,262
Cost Centers Not Benefiting Medicare (pages 13/14)	52,178
Reported Costs Not Supported by Accounting Records (pages 14/15) (see 2 below)	127,996
Unsupported Costs (page 15) (see 2 below)	28,282
Building Lease Cost Adjustment Error (pages 15/16)	79,229
Excess of Executive Compensation Increases Over ECI Allocated to Medicare (pages 16/19)	233,239
	$1,653,079

1. We are concerned that an error of this magnitude occurred and will enhance the FACP review process as recommended. During preparation of the FY 1993 FACP, the preparer went on medical leave causing the person who would have reviewed the FACP to have to complete the preparation in a limited time frame in order to meet the deadline.
2. We believe these records were in existence and have been misplaced due to organizational and location changes between 1992 and the time of the audit, late 1995. As the costs not claimed exceed the amount questioned, we believe further research would not be cost effective.

Excess of Executive Compensation Increases Over ECI Allocated to Medicare

We are not sufficiently familiar with the underlying principles behind the ECI compilation to provide comments on the appropriateness of its application to the situation in which it is being applied. We do believe that its application to a carefully developed performance driven bonus program is questionable. The bonus program is driven by Company, organization, and individual performance factors that vary from year to year and bear no resemblance to our limited understanding of the ECI. Further, regular pay compensation increases for all employees are driven by documented reviews of performance giving due consideration for both internal and external factors. Sometimes higher increases are due to the assumption of additional responsibilities.

Bonuses are accrued in the year earned, but are paid usually in March of the following year when the performance indicators on which they are based have been compiled. The bonus paid in the year after an employee's start date is prorated according to the time of service in that (prior) year. Therefore, two of the executives in the computation of excess increases over ECI were paid prorated bonuses in the 'base' year used for the calculation of the excess. Furthermore, payout should not be prorated in the year in which an executive leaves the Company because that bonus applies to performance in the prior year and was accrued in that prior year.

An anomaly arose in 1994 whereby two employees included in the calculation availed themselves of the Company's offer to buy down vacation pay in 1994 to help fund their earthquake damage. This had some distortionary effect on the apparent increases in 1994 over 1993.

Because allocable costs not claimed exceed questioned costs and because we question the appropriateness of using the ECI in this context, we are not submitting proposed revisions to the calculation. Furthermore, it would be most time consuming to research the rationale for individual pay increases in each of the years 1991 through 1994.

We request that the audit report identify the contractual requirement to conform with increases in remuneration from year to year as "determined by the Department of Labor, Bureau of Labor Statistics as reported by the Employment Cost Index (ECI)".

We want to thank you and your staff for the professional manner in which this audit was conducted and for affording us the opportunity to discuss the various issues raised during the on-site work. This spirit of cooperation clearly facilitated the timely completion of this audit.

Sincerely,

Michael J. Lohnberg, V.P.
Corporate Auditor

MJL:lw:553medau

cc: Jacqueline A. Anderson, G.M., Medicare/FEP Operations