

# The Administrative Expenses the National Heritage Insurance Company Charged to the Health and Human Services Commission in Fiscal Year 2002

June 9, 2003

Members of the Legislative Audit Committee:

Our audit of the administrative expenses that the National Heritage Insurance Company (NHIC) charged to the Health and Human Services Commission (Commission) in fiscal year 2002 has led us to conclude that NHIC should refund \$24,948,068 in unallowable expenditures it inappropriately charged to the Commission for processing Medicaid claims in fiscal year 2002. This amount includes the following:

- \$9,457,736 for unallowable expenditures. NHIC did not make these expenditures in compliance with contract terms. For example, some expenditures were unallowable because they were associated with NHIC's development of Compass 21 (a new Medicaid claims processing system that NHIC created for the Commission). Others were unallowable because they were for expenditures that NHIC made prior to fiscal year 2002.
- \$11,981,522 in unallowable employee payroll and bonus costs. The majority of this refund is necessary because NHIC inappropriately charged the Commission for payroll associated with the development of Compass 21.
- \$3,508,810 in unallowable depreciation costs. This refund is necessary because NHIC (1) inappropriately accelerated the depreciation of assets and (2) inappropriately charged the Commission for depreciation on assets it used to develop Compass 21.

The attachment to this letter contains additional details on the amounts listed above. The population of NHIC expenditures we audited did not include the unallowable expenditures that NHIC had already identified. Therefore, the \$24,948,068 amount that NHIC should refund to the Commission does not duplicate expenditures that NHIC had already identified as unallowable.

The \$24,948,068 amount that NHIC should refund to the Commission also does not include the general and administrative fee and markup fee that NHIC charged the Commission related to these expenditures. The current general and administrative fee NHIC charges to the Commission is 9.4116 percent of total expenditures, but that rate is subject to change pending the results of a federal audit. The markup fee that NHIC charges the Commission is 15 percent of the sum of total expenditures and the general and administrative fee.

When the general and administrative fee is finalized, NHIC should refund the Commission for the amount of the general and administrative fee and the markup fee associated with the \$24,948,068 in unallowable expenditures we identified. If the general and administrative fee remains unchanged at 9.4116 percent, the total amount of unallowable expenditures, associated general and administrative fees, and markup fees that NHIC should refund to the Commission for fiscal year 2002 will be \$31,390,492.

## Summary of Objective, Scope, and Methodology

Our objective was to determine the validity of expenditures that NHIC charged the Commission in fiscal year 2002 to administer Medicaid claims. Our agreement with the Commission specified additional objectives. The additional objectives include auditing accounts receivable balances that providers owe to the State, the accuracy of claim counts, and certain reserve and stabilization fund balances.

Our scope was the administrative expenditures that NHIC charged to the Commission in fiscal year 2002 (excluding expenditures that NHIC had already identified as unallowable).

The audit methodology consisted of collecting information, performing selected audit tests and other procedures, and analyzing and evaluating the results against established criteria. This audit was conducted in accordance with generally accepted government auditing standards.

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*In An Audit of the Administrative Expenses the National Heritage Insurance Company Charged to the Health and Human Services Commission* (SAO Report Number 03-016, January 2003), we reported that NHIC should refund \$15,841,385 in unallowable expenditures it inappropriately charged the Commission in fiscal year 2001. If the general and administrative fee remains unchanged at 9.4116 percent, the total amount of unallowable expenditures, associated general and administrative fees, and markup fees that NHIC should refund to the Commission for fiscal year 2001 will be \$19,932,160.

This report does not include our determinations as a result of auditing (1) accounts receivable balances that providers owe to the State, (2) the accuracy of claim counts, and (3) certain reserve and stabilization fund balances. Our work in these areas will be communicated in a separate report.

The Commission has reviewed the findings contained in this report.

We thank the Commission for its cooperation during this audit. If you have any questions, please contact Joanna B. Peavy, CPA, Audit Manager, at (512) 936-9500.

Sincerely,

Lawrence F. Alwin, CPA  
State Auditor

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Attachment

cc: Mr. Albert Hawkins, Commissioner, Health and Human Services Commission

# Detailed Results

Chapter 1

## ***NHIC Should Refund \$9,457,736 in Unallowable Expenditures It Charged to the Commission in Fiscal Year 2002***

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### Summary

Based on the results of our random sample testing, we project that the National Heritage Insurance Company (NHIC) should refund \$9,457,736 in unallowable expenditures that it charged to the Health and Human Services Commission (Commission) in fiscal year 2002.

We derived our audit conclusions from testing a random sample and projecting the results over the entire population of expenditures. The two primary reasons the expenditures were unallowable include the following:

- The expenditure did not occur in fiscal year 2002, but NHIC charged it to fiscal year 2002. Examples of these expenditures include:
  - ♦ \$170,845 in expenditures for information technology contractors that NHIC made prior to fiscal year 2002 but charged to the Commission in fiscal year 2002.
  - ♦ \$3,693 for closing costs associated with selling the home of the NHIC Chief Operating Officer. The closing took place on July 7, 2001 (which was in fiscal year 2001). In addition, as we previously reported in *An Audit of the Administrative Expenses the National Heritage Insurance Company Charged to the Health and Human Services Commission* (SAO Report Number 03-016, January 2003), NHIC transferred its Chief Operating Officer from South Africa to Austin. However, the house that the Chief Operating Officer sold was in Argyle, Texas. Therefore, NHIC should be allowed to charge the Commission only for the Chief Operating Officer's moving expenses or for the Chief Operating Officer's home-selling and home-buying expenses, but not both.
- The expenditure was for the development of Compass 21 (a new Medicaid claims processing system that NHIC created for the Commission), but NHIC charged it to Operations (the unit that administers Medicaid claims). An example of one of these expenditures is the \$5,563.25 that NHIC paid for hardware and

#### Summary of Our Sampling and Projection Methodology

To sample expenditures and project the results to the population, we did the following:

- We selected a random sample of 192 transactions (totaling \$2,108,591) from the population of expenditures that NHIC charged to the Commission in fiscal year 2002. The population from which we drew our sample excluded payroll and payroll-related items, depreciation, and expenditures already identified by NHIC as unallowable under the Federal Acquisition Regulation (FAR). To determine the sample size of 192, we set our confidence level at 95 percent and selected a 10 percent desired level of sampling precision.
- We tested the 192 transactions in our sample for allowability and determined that 38 of them were unallowable.
- Based on our test results, we projected that the total refund should be \$9,457,736.

maintenance on a Tandem computer system. Although NHIC charged this expenditure to Operations, NHIC's documentation indicates that this computer system was used on the development of Compass 21.

Chapter 2

## ***NHIC Should Refund \$11,981,522 in Employee Payroll and Bonus Costs It Charged to the Commission in Fiscal Year 2002***

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### **Summary**

NHIC should refund \$11,981,522 in employee payroll and bonus costs it inappropriately charged to the Commission in fiscal year 2002. The majority of these costs were associated with the development of Compass 21.

The payroll and bonus costs that NHIC should refund include the following:

- Between July 2001 and August 2001, NHIC inappropriately reassigned 195 NHIC employees from Compass 21 development to Operations. NHIC charged the Commission \$10,903,586 for the payroll costs associated with these 195 employees during fiscal year 2002. Prior to July 2001, but during fiscal year 2001, NHIC also reassigned 19 NHIC employees from Compass 21 development to Operations. NHIC charged the Commission \$886,456 for the payroll costs associated with these 19 employees during fiscal year 2002.
- During fiscal year 2002, NHIC inappropriately charged the Commission for \$191,480 in bonuses that NHIC paid to NHIC employees who worked on Compass 21 development.

NHIC prepared manpower allocation percentage reports to allocate "manpower months" to Compass 21 development and Operations. Based on historical trends indicated in those reports, NHIC has not supported that these employees worked to process Medicaid claims or that it needed 195 additional employees when it began using Compass 21 in August 2001. For example, as Table 1 shows, when the number of claims NHIC processed increased 13.38 percent from fiscal year 1999 to fiscal year 2000, the manpower months NHIC used to process those claims increased by 4.49 percent. In comparison, however, after the Commission began using Compass 21, the number of claims it processed increased by 16.27 percent, but the manpower months NHIC used to process those claims increased by 21.35 percent.

**Definition of a  
Manpower Month**

One manpower month equals the total number of days available to work in a month multiplied by eight hours per day.

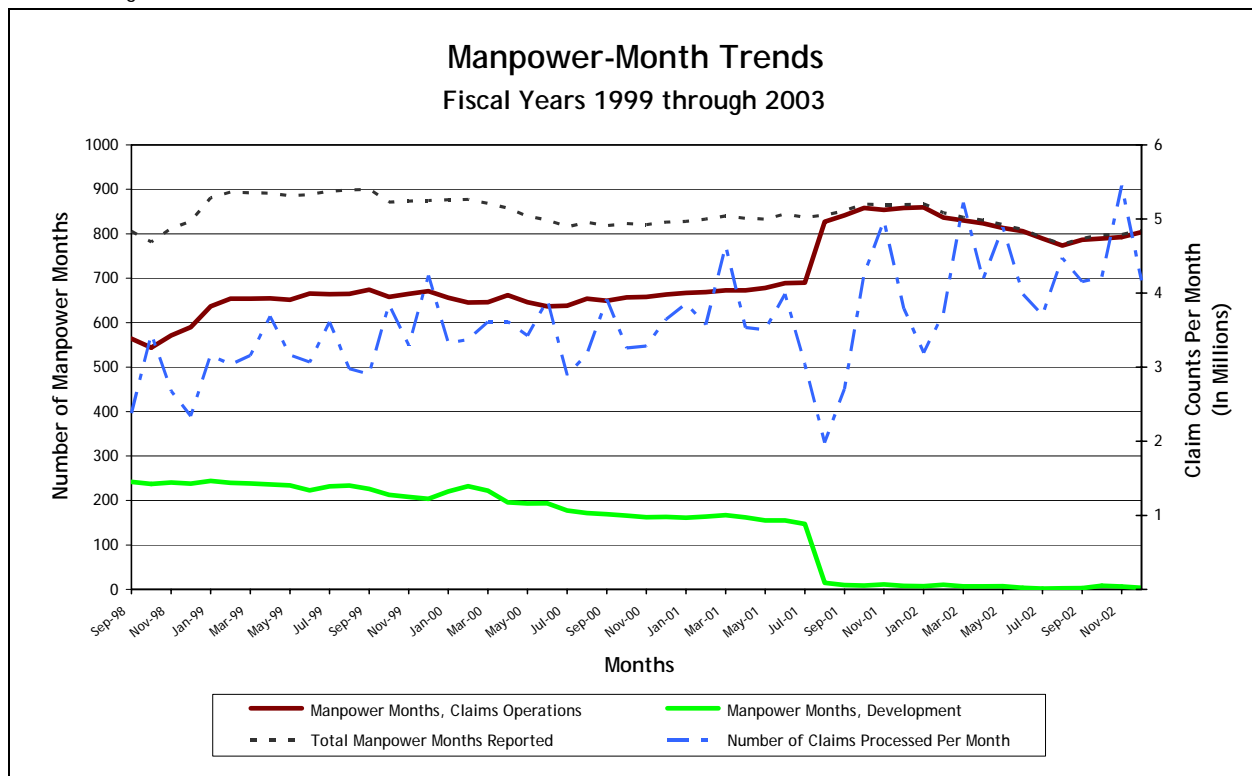
Table 1 - The number of manpower months NHIC used to process Medicaid claims after the Commission began using Compass 21 in August 2001 increased significantly.

Manpower Months NHIC Used to Process Medicaid Claims							
	Fiscal Year 1999	Fiscal Year 2000		Fiscal Year 2001		Fiscal Year 2002	
		Fiscal Year 2000	Increase from Fiscal Year 1999	Fiscal Year 2001	Increase from Fiscal Year 2000	Fiscal Year 2002	Increase from Fiscal Year 2001
Number of Medicaid claims NHIC processed	36,690,801	41,599,975	13.38%	42,219,843	1.49%	49,089,325	16.27%
Manpower months NHIC used to process Medicaid claims	7,514.58	7,852.00	4.49%	8,193.00	4.35%	9,943.00	21.35%

Source: NHIC manpower, claims operations, infrastructure, and run-out allocations reports

As Figure 1 shows, the number of manpower months NHIC charged to Operations increased significantly in August 2001, but the number of manpower months it charged to Compass 21 development decreased significantly. However, the general trend in the growth of the number of claims processed each month did not change significantly.

Figure 1 - The number of manpower months NHIC charged to Compass 21 development and Operations changed significantly in August 2001.



Source: NHIC manpower allocation percentage, claims operations, and infrastructure run-out allocations reports

We based our analysis of payroll on the manpower reports that NHIC uses to allocate payroll costs to Compass 21 development and Operations.

## ***NHIC Should Refund \$3,508,810 in Depreciation Costs It Charged to the Commission in Fiscal Year 2002***

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### **Summary**

NHIC should refund a total of \$3,508,810 in depreciation costs that it inappropriately charged to the Commission in fiscal year 2002. NHIC overcharged the Commission for depreciation in two ways.

#### **Contractual, Regulatory, and EDS Policy Requirements Regarding Asset Depreciation**

- A 1997 memo NHIC wrote as part of its negotiations to administer Medicaid claims in Texas specified that NHIC would charge depreciation “through month 60 of the contract but not beyond.” The original term of NHIC’s contract with the Commission was 48 months (September 1998 through August 2002), with four one-year options.
- NHIC’s contract with the Commission specifies that certain federal regulations—Code of Federal Regulations, Title 48, Subpart 31.2 (Contracts with Commercial Organizations); and Chapter 99 (Cost Accounting Standards)—govern the allowability of costs it can charge the Commission to administer Medicaid claims. These regulations specify that:
  - ♦ Depreciation is a charge to current operations that distributes the cost of a tangible asset over the useful life of the asset in a systematic and logical manner.
  - ♦ Depreciation costs should be a reasonable measure of the expiration of service potential of the asset. The service life is the period of usefulness of a tangible asset.
- A contract amendment to extend NHIC’s contract with the Commission through February 2004 specified that NHIC should depreciate assets over their standard useful life. The amendment allowed NHIC to charge for the full asset only if, at the end of the contract, the State retained the asset.
- EDS Accounting Policy 003-060 states that: “The cost of all capitalizable assets should be depreciated over the estimated useful lives of the assets.... The entire asset value must be depreciated within the contract model. If the contract life is shorter than the asset life, the remaining net book value of the asset must be expensed in the last month of the contract model.”
- Both EDS’s asset useful life table and NHIC’s GIT/Property Category Cross Reference table specify that the useful life of computers and computer-related equipment is 60 months.

NHIC’s contract with the Commission and federal regulations cited within that contract require NHIC to depreciate assets over their useful life. The contract allows NHIC to charge the Commission for depreciation on assets (primarily computers and computer-related equipment) it uses to administer Medicaid claims. However, NHIC inappropriately accelerated depreciation on assets it acquired during and after April 2000. Instead of depreciating those assets over what it normally considered to be the assets’ useful life (60 months), NHIC depreciated them over the remainder of the term of its contract with the Commission.

As of April 2000, 28 months remained on NHIC’s contract with the Commission. Therefore, even if the useful life of an asset NHIC acquired in April 2000 was 60 months, NHIC accelerated the depreciation of that asset so that it could fully depreciate the asset within 28 months. As a result, NHIC charged the Commission for depreciation costs that were higher than its contract and federal regulations permitted (see text box for additional details). NHIC did not inform the Commission of its decision to accelerate the depreciation of assets.

NHIC’s contract with the Commission also does not permit NHIC to charge the Commission for depreciation on assets (primarily computers and computer-related equipment) it used to develop Compass 21. However, after the Commission began using Compass 21, NHIC inappropriately charged the Commission for depreciation on those assets in fiscal year 2002.