

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**NATIONAL HERITAGE INSURANCE
COMPANY CLAIMED SOME
UNALLOWABLE BENEFIT
RESTORATION PLAN COSTS FOR
FISCAL YEARS 2003 THROUGH 2009**

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Office of Inspector General

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OFFICE OF AUDIT SERVICES FINDINGS AND OPINIONS

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

EXECUTIVE SUMMARY

National Heritage Insurance Company, a Medicare contractor, claimed unallowable Benefit Restoration Plan costs of \$219,000 for fiscal years 2003 through 2009.

WHY WE DID THIS REVIEW

The Centers for Medicare & Medicaid Services (CMS) reimburses a portion of its contractors' Benefit Restoration Plan (BRP) costs. In claiming BRP costs, contractors must follow cost reimbursement principles contained in the Federal Acquisition Regulation (FAR), Cost Accounting Standards, and the Medicare contracts. Previous Office of Inspector General reviews found that Medicare contractors did not always correctly identify BRP costs.

The objective of this review was to determine whether the BRP costs claimed by National Heritage Insurance Company (NHIC) for Medicare reimbursement for fiscal years (FYs) 2003 through 2009 were allowable and correctly claimed.

BACKGROUND

NHIC, a subsidiary of Hewlett-Packard Enterprise Systems (HPES) (formerly known as Electronic Data Systems Corporation (EDS)), administered Medicare Part B carrier operations under cost reimbursement contracts with CMS until the contractual relationship ended on June 1, 2009. With the implementation of Medicare contracting reform, NHIC continued to perform Medicare work after being awarded the Medicare administrative contractors' contracts for Medicare Durable Medical Equipment Jurisdiction A and Medicare Parts A and B Jurisdiction 14, effective July 1, 2006, and November 14, 2008, respectively. Although our report is addressed to HPES, we will associate the term NHIC with our findings and recommendation.

HPES offers two nonqualified defined-benefit pension plans: the EDS BRP and the EDS 1998 Supplemental Executive Retirement Plan (SERP). The primary purpose of the BRP is to provide benefits to a select group of management or highly compensated employees. More specifically, the BRP is a nonqualified defined-benefit pension plan designed to restore benefits lost because of the Internal Revenue Code limits applicable to the regular qualified pension plan.

This report will address NHIC's BRP costs that it claimed for Federal reimbursement under its Medicare Part B contracts. We are separately reviewing the EDS SERP pension costs that NHIC claimed.

WHAT WE FOUND

NHIC claimed \$542,606 in BRP costs for FYs 2003 through 2009; however, we determined that allowable BRP costs for this time period were \$323,499. The difference, \$219,107, represented unallowable BRP costs that NHIC claimed on its Final Administrative Cost Proposals (FACPs) for FYs 2003 through 2009. NHIC claimed these unallowable BRP costs because it did not calculate them in accordance with Federal regulations and the Medicare contracts' requirements.

In addition, during our review of BRP benefit payments paid to participants during FYs 2003 through 2009, we noted that some payments appeared to be based on excessive compensation. While none of these individuals was considered one of the five most highly compensated employees in management positions at each home office and each segment of the Medicare contractor, these participants' compensation exceeded the compensation limits described in FAR 31.205-6(p). We reviewed 33 benefit payments that contained compensation in excess of the compensation limits described in FAR 31.205-6(p) and determined that \$52,761 in BRP payments may have been unallowable for Medicare reimbursement. Therefore, we are setting aside \$52,761 in claimed BRP costs for adjudication by CMS.

WHAT WE RECOMMEND

We recommend that NHIC:

- revise its FACPs for FYs 2003 through 2009 to reduce its claimed BRP costs by \$219,107 and
- work with CMS to determine the allowability of \$52,761 in BRP costs that NHIC claimed for Medicare reimbursement for FYs 2003 through 2009.

AUDITEE COMMENTS AND OUR RESPONSE

Our draft report included a finding that NHIC based its claims for Medicare reimbursement on an incorrect cost accounting method; this finding remains part of this final report. Our draft report also included a finding that NHIC claimed \$271,270 of unallowable BRP costs on its FACPs for FYs 2003 through 2009 because it used unreasonable compensation when calculating its BRP costs for Medicare reimbursement. In written comments on that draft report, HPES addressed our findings but not our recommendation. HPES agreed with us that NHIC based its claim for Medicare reimbursement on an incorrect cost accounting method. HPES disagreed with our draft report's second finding that NHIC used unreasonable compensation when calculating its BRP costs for Medicare reimbursement. Specifically, HPES disagreed with our interpretation of several provisions of the relevant Federal regulations insofar as reasonableness of compensation is concerned; with the manner in which those regulations use the compensation limits established by the Office of Federal Procurement Policy; and with our direct association of BRP costs with compensation costs.

After reviewing HPES's comments and consulting with our Office of Counsel to the Inspector General, we revised our monetary finding (the \$271,270 in costs we had questioned in our draft report) and agreed to limit our evaluation of executive compensation to only the five most highly compensated employees in management positions at each home office and each segment of the Medicare contractor. Accordingly, we have recalculated BRP payments in accordance with FAR 31.205-6(p) and have adjusted the associated findings and recommendations in this final report. These adjustments led us to determine that NHIC claimed \$219,107 of unallowable BRP costs on its FACPs for FYs 2003 through 2009 and that NHIC claimed \$52,761 in BRP payments that may have been unallowable for Medicare reimbursement.

However, we disagree with HPES's assertion that BRP costs are not directly associated with compensation costs. We note, too, that several of the supporting arguments that HPES advanced to support its comments were of little or no relevance to our audit. We therefore maintain that our findings, to include the costs related to NHIC's use of potentially excessive compensation when calculating its BRP costs for Medicare reimbursement (that is, the costs that we are setting aside for adjudication by CMS), remain valid and solidly supported by relevant regulations.

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INTRODUCTION

WHY WE DID THIS REVIEW

The Centers for Medicare & Medicaid Services (CMS) reimburses a portion of its contractors' Benefit Restoration Plan (BRP) costs. In claiming BRP costs, contractors must follow cost reimbursement principles contained in the Federal Acquisition Regulation (FAR), Cost Accounting Standards (CAS), and the Medicare contracts. Previous Office of Inspector General reviews found that Medicare contractors did not always correctly identify BRP costs.

OBJECTIVE

Our objective was to determine whether the BRP costs claimed by National Heritage Insurance Company (NHIC) for Medicare reimbursement for fiscal years (FYs) 2003 through 2009¹ were allowable and correctly claimed.

BACKGROUND

NHIC, a subsidiary of Hewlett-Packard Enterprise Systems (HPES) (formerly known as Electronic Data Systems Corporation (EDS)), administered Medicare Part B carrier operations under cost reimbursement contracts with CMS until the contractual relationship ended on June 1, 2009. With the implementation of Medicare contracting reform,² NHIC continued to perform Medicare work after being awarded the MAC contracts for Medicare Durable Medical Equipment (DME) Jurisdiction A and Medicare Parts A and B Jurisdiction 14, effective July 1, 2006, and November 14, 2008, respectively.^{3, 4} Although our report is addressed to HPES, we will associate the term NHIC with our findings and recommendation.

Defined-Benefit Plans

HPES offers two nonqualified defined-benefit pension plans: the EDS BRP and the EDS 1998 Supplemental Executive Retirement Plan (SERP). The primary purpose of the BRP is to provide benefits to a select group of management or highly compensated employees. More specifically,

¹ Through the June 1, 2009, contract termination date mentioned below.

² Section 911 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, P. L. No. 108-173, required CMS to transfer the functions of fiscal intermediaries and carriers to Medicare administrative contractors (MACs) between October 2005 and October 2011. Most, but not all, of the MACs are fully operational; for jurisdictions where the MACs are not fully operational, the fiscal intermediaries and carriers continue to process claims. For purposes of this report, the term "Medicare contractor" means the fiscal intermediary, carrier, or Medicare administrative contractor, whichever is applicable.

³ Medicare DME Jurisdiction A comprises the States of Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont, as well as the District of Columbia.

⁴ Medicare Parts A and B Jurisdiction 14 comprises the States of Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont.

the BRP is a nonqualified defined-benefit pension plan designed to restore benefits lost because of the Internal Revenue Code limits applicable to the regular qualified pension plan.

Accounting Methodologies

The Medicare contracts require NHIC to calculate BRP costs in accordance with the FAR and CAS 412 and 413. The FAR and CAS require that the costs for nonqualified defined-benefit plans be measured under either the accrual method or the pay-as-you-go method. Under the accrual method, allowable costs are based on the annual contributions that the employer deposits into its trust fund. For nonqualified defined-benefit plans that are not funded through the use of a funding agency, costs are to be accounted for under the pay-as-you-go method. This method is based on the actual benefits paid to participants, which are comprised of lump-sum payments plus annuity payments.

This report will address NHIC's BRP costs that it claimed for Federal reimbursement under its Medicare Part B contracts. We are separately reviewing the EDS SERP pension costs that NHIC claimed.

HOW WE CONDUCTED THIS REVIEW

We reviewed \$542,606 of BRP costs claimed by NHIC for Medicare reimbursement on its Final Administrative Cost Proposals (FACPs) for FYs 2003 through 2009.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix A contains details of our audit scope and methodology.

FINDINGS

NHIC claimed \$542,606 in BRP costs for FYs 2003 through 2009; however, we determined that allowable BRP costs for this time period were \$323,499. The difference, \$219,107, represented unallowable BRP costs that NHIC claimed on its FACPs for FYs 2003 through 2009. NHIC claimed these unallowable BRP costs because it did not calculate them in accordance with Federal regulations and the Medicare contracts' requirements.

In addition, during our review of BRP benefit payments paid to participants during FYs 2003 through 2009, we noted that some payments appeared to be based on excessive compensation. While none of these individuals was considered one of the five most highly compensated employees in management positions at each home office and each segment of the Medicare contractor, these participants' compensation exceeded the compensation limits described in FAR 31.205-6(p). We reviewed 33 benefit payments that contained compensation in excess of the compensation limits described in FAR 31.205-6(p) and determined that \$52,761 in BRP

payments may have been unallowable for Medicare reimbursement. Therefore, we are setting aside \$52,761 in claimed BRP costs for adjudication by CMS.

CLAIMED BENEFIT RESTORATION PLAN COSTS

NHIC submitted BRP costs of \$542,606 for Medicare reimbursement on its FACP for FYs 2003 through 2009. We calculated the allowable BRP costs in accordance with the FAR and the CAS. For details on the Federal requirements, see Appendix B.

UNALLOWABLE BENEFIT RESTORATION PLAN COSTS CLAIMED

We determined that the allowable BRP costs for FYs 2003 through 2009 were \$323,499. Thus, NHIC claimed \$219,107 of unallowable BRP costs on its FACP for this time period. This overclaim occurred primarily because NHIC did not calculate its BRP costs in accordance with Federal regulations and the Medicare contracts' requirements. More specifically, NHIC based its claim for Medicare reimbursement on an incorrect cost accounting method and used unallowable compensation when calculating its BRP costs for Medicare reimbursement.

In accordance with the FAR and the CAS, we calculated the allowable BRP pension costs based on periodic payments made to BRP recipients, plus a 15-year amortization of lump-sum BRP payments, in accordance with CAS 412-50(b)(3). Accordingly, we determined that the allowable pay-as-you-go BRP pension costs for FYs 2003 through 2009 totaled \$323,499.

Costs Based on Incorrect Cost Accounting Method

The Medicare contracts require NHIC to calculate BRP costs in accordance with the FAR and CAS 412 and 413. NHIC's BRP did not satisfy the requirements for accrual accounting as specified in CAS 412.50(c)(3). (See Appendix A.) Therefore, NHIC should have accounted for its BRP costs using the pay-as-you-go cost method in accordance with CAS 412.50(b)(3). However, NHIC incorrectly assigned its BRP costs to cost accounting periods using an accrual cost accounting method.

Costs Based on Unallowable Compensation

NHIC identified \$45,766,197⁵ as the allocable BRP annuity costs for calendar years (CYs) 2002 through 2009.⁶ In our review of the benefit payment calculations, we determined that NHIC based its claimed BRP costs, with respect to the annuity payments, on unallowable compensation. We obtained and recalculated 11 benefit payments, using the compensation limits described in FAR 31.205-6(p) (Appendix B). Each of these 11 payments was made on behalf of

⁵ We also reviewed the compensation used to determine the lump sum payments, which totaled \$6,140,907. Our review determined that the lump sum payments were based on reasonable compensation.

⁶ NHIC gave us a list of the actual benefit payments made to BRP recipients and organized that list on a CY basis. NHIC also provided its Medicare line of business information on a CY basis. Because Medicare reimbursement is on an FY basis, we converted those CY benefit payments and the Medicare line of business information to an FY basis by taking, for each FY, 1/4 of the prior CY's cost plus 3/4 of the current CY's cost.

1 of the 5 most highly compensated employees in management positions at each home office and each segment of the Medicare contractor and should have been limited to the compensation benchmarks determined by the Office of Federal Procurement Policy (OFPP). In our calculations for these 11 payments, we limited each participant's compensation for the year in which he or she was considered 1 of the 5 most highly compensated employees in accordance with FAR 31.205-6(p). We calculated the allocable BRP costs for the period of CYs 2002 through 2009 to be \$38,477,951. Therefore, NHIC overstated the allocable BRP costs by \$7,288,247 because it did not limit executive compensation in accordance with FAR 31.205-6(p) when requesting Medicare reimbursement.

Table 1 below compares allowable BRP costs with the costs claimed on NHIC's FACPs. Appendix C contains additional detail on the allowable costs.

Table 1: Medicare BRP Costs			
Fiscal Year	Allowable Per Audit	Claimed by NHIC	Difference
2003	\$30,794	\$7,435	\$23,359
2004	37,767	139,594	(101,827)
2005	42,510	109,222	(66,712)
2006	44,308	95,513	(51,205)
2007	52,820	85,486	(32,666)
2008	72,473	96,427	(23,954)
2009	42,827	8,929	33,898
Total	\$323,499	\$542,606	(\$219,107)

Because NHIC did not calculate its BRP costs in accordance with Federal regulations and the Medicare contracts' requirements, it claimed \$219,107 in unallowable BRP costs.

PAYMENTS THAT MAY HAVE BEEN BASED ON EXCESSIVE COMPENSATION

While reviewing calculations of payments made to participants during CYs 2002 through 2009, we noted that NHIC based its claimed BRP costs, with respect to the annuity payments, on compensation that appeared to be excessive.

We based our determination of excessive compensation on the benchmark for reasonable compensation that is provided by FAR 31.205-6(p) (Appendix B). We obtained and recalculated 33 benefit payments using the compensation limits described in FAR 31.205-6(p). We calculated the BRP costs associated with these 33 benefit payments to be \$52,761 for the period of FYs 2003 through 2009. We based our calculation on the difference between the allowable costs calculated above and the amounts that would have been allowable if compensation were limited to the OFPP benchmarks as specified in FAR 31.205-6(p).

Accordingly, we are setting aside \$52,761 in claimed BRP costs for FYs 2003 through 2009 for adjudication by CMS, as shown in Table 2 on the following page.

Table 2: BRP Costs Set Aside	
Fiscal Year	Amount Set Aside
2003	\$6,296
2004	7,113
2005	7,902
2006	8,126
2007	9,110
2008	9,147
2009	5,067
Total	\$52,761

RECOMMENDATIONS

We recommend that NHIC:

- revise its FACPs for FYs 2003 through 2009 to reduce its claimed BRP costs by \$219,107 and
- work with CMS to determine the allowability of \$52,761 in BRP costs that NHIC claimed for Medicare reimbursement for FYs 2003 through 2009.

AUDITEE COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

Our draft report included a finding that NHIC based its claims for Medicare reimbursement on an incorrect cost accounting method; this finding remains part of this final report. Our draft report also included a finding that NHIC claimed \$271,270 of unallowable BRP costs on its FACPs for FYs 2003 through 2009 because it used unreasonable compensation when calculating its BRP costs for Medicare reimbursement. In written comments on that draft report, HPES addressed our findings but not our recommendation. HPES agreed with us that NHIC based its claim for Medicare reimbursement on an incorrect cost accounting method. HPES disagreed with our draft report's second finding that NHIC used unreasonable compensation when calculating its BRP costs for Medicare reimbursement.

A summary of HPES's comments on our draft report's second finding and our responses follows. HPES's comments, excluding seven pages which we removed because they contain personally identifiable information and proprietary information, appear as Appendix D.

After reviewing HPES's comments and consulting with our Office of Counsel to the Inspector General, we revised our monetary finding (the \$271,270 in costs we had questioned in our draft report) and agreed to limit our evaluation of executive compensation to only the five most highly compensated employees in management positions at each home office and each segment of the Medicare contractor. Accordingly, we have recalculated BRP payments in accordance with FAR 31.205-6(p) and have adjusted the associated findings and recommendations in this final report. These adjustments led us to determine that NHIC claimed \$219,107 of unallowable BRP costs on its FACPs for FYs 2003 through 2009 and that NHIC claimed \$52,761 in BRP payments that may have been unallowable for Medicare reimbursement.

However, we disagree with HPES's assertion that BRP costs are not directly associated with compensation costs. We note, too, that several of the supporting arguments that HPES advanced to support its comments were of little or no relevance to our audit. We therefore maintain that our findings, to include the costs related to NHIC's use of potentially excessive compensation when calculating its BRP costs for Medicare reimbursement (that is, the costs that we are setting aside for adjudication by CMS), remain valid and solidly supported by relevant regulations.

ASSOCIATION OF BENEFIT RESTORATION PLAN COSTS WITH COMPENSATION COSTS

Auditee Comments

HPES disagreed with our position that BRP costs are directly associated with compensation costs. HPES stated that our citation of FAR 31.201-6(a) was incomplete and was thus applied erroneously. The full provision, as HPES quoted in its comments, includes a definition of "directly associated costs" as well as the following statement: "When an unallowable cost is incurred, its directly associated costs are also unallowable." HPES said that this quoted statement "... makes it clear that the directly associated costs would only be unallowable if the costs with which it is associated has [sic] been deemed to be unallowable."

Furthermore, HPES stated that BRP costs were developed using a number of factors, including compensation, employee's current age, employee's age on initial hiring date, employee's age on re-hire date, employee's age on July 30, 1998, employee's years of service, employee's post-age-35 years of service, current year interest rate, Social Security wage base for the current year, Internal Revenue Service code 401(a)(17) annual compensation limit of the current year, and employee's EDS retirement plan payment. HPES concluded that because BRP payments were calculated based on these and other factors and were not generated solely as a result of compensation, "... any assertion that BRP costs are 'directly associated' costs is not supported by the regulations."

Office of Inspector General Response

We maintain that BRP costs are in fact directly associated with compensation costs and that this report does not cite regulations misleadingly or apply them erroneously. FAR 31.001 defines "directly associated cost" as "any cost which is generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred." This definition, though not specifically quoted in Appendix B, is nearly word for word the same as the FAR 31.201-6(a) definition that HPES quoted in its comments. In these terms, BRP costs are *directly* associated with compensation. In fact, the first computation of the benefit payment for the BRP is to determine the participant's final average pay. The final average pay of the participant is then used as the basis to determine the benefit that will be paid to the participant; the other factors merely adjust the participant's benefit amount in accordance with the plan document. Therefore, we believe that the BRP benefit is directly associated with the compensation level of the participant.

HPES cited one other provision of FAR 31.201-6(a) in this portion of its comments: “When an unallowable cost is incurred, its directly associated costs are also unallowable.” HPES’s interpretation of this statement is inaccurate. That interpretation pivots on HPES’s insertion of the word “only” in the interpretive comment quoted in “Auditee Comments” above. This inserted word narrows the FAR’s causative relationship between “unallowable cost” and “directly associated costs” in a manner that distorts the meaning and shifts the focus of that provision of the FAR.

APPLICABILITY OF FEDERAL ACQUISITION REGULATION 31.205-6(p)

Auditee Comments

In responding to our draft report, HPES based many of its comments on its interpretation of FAR 31.205-6. In addition to making the arguments that we have summarized above, HPES made further reference, in the last two pages of its written comments, to its disagreement with our application of FAR 31.205-6(p). HPES stated that any assertion that BRP costs are unallowable based on this provision of the FAR is not supported by the regulations in that (1) defined-benefit pension plans are not included in the definition of limited compensation, (2) the statutory limitation does not apply to all employees, and (3) the costs are not unallowable as directly associated costs.

Office of Inspector General Response

We disagree with HPES’s assertions that (1) defined-benefit pension plans are not included in the definition of limited compensation, (2) the statutory limitation does not apply to all employees, and (3) the costs are not unallowable as directly associated costs because they are not supported by the regulations. FAR 31.205-6(p) places limits on the total compensation that is allowable for the named elements of compensation and does not exempt other elements of compensation from allowability restrictions. In fact, FAR 31.205-6(a)(5) makes it clear that “... costs that are unallowable under other paragraphs of this Subpart 31.2 are not allowable under this subsection 31.205-6 solely on the basis that they constitute compensation for personal services.” FAR 31.205-6(b)(2) does not exclude pension benefits and other forms of deferred compensation from the individual compensation elements that are to be considered when assessing the reasonability of the total compensation package. In addition, FAR 31.201-2(a) states that the use of compensation deemed to be unreasonable is unallowable.

APPENDIX A: AUDIT SCOPE AND METHODOLOGY

SCOPE

We reviewed \$542,606 of BRP costs that NHIC claimed for Medicare reimbursement on its FACPs for FYs 2003 through 2009.

Achieving our objectives did not require us to review NHIC's overall internal control structure. We reviewed controls relating to the BRP costs claimed for Medicare reimbursement to ensure that those costs were allowable in accordance with the FAR and the CAS.

We performed our audit work at our office in Jefferson City, Missouri, in October 2013.

METHODOLOGY

To accomplish our objective, we:

- reviewed the portions of the FAR, CAS, and Medicare contracts applicable to this audit;
- reviewed information provided by NHIC to identify the amount of nonqualified defined-benefit plan costs claimed for Medicare reimbursement for FYs 2003 through 2009;⁷
- reviewed Total Company benefit payment information and Total Company salary information provided by NHIC for the BRP; and,
- using the information provided by NHIC, determined the amount of annuities paid to participants and calculated the allowable amortizable benefit for participants who received a lump-sum benefit payment in accordance with Federal regulations.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

⁷ Through the June 1, 2009, contract termination date.

APPENDIX B: FEDERAL REQUIREMENTS RELATED TO BENEFIT RESTORATION PLAN COSTS

FEDERAL REGULATIONS

Federal regulations (CAS 412.50(b)(3)) state that for defined-benefit plans accounted for under the pay-as-you-go cost method, the amount of pension cost assignable to a cost accounting period shall be measured as the sum of:

- the net amount for any periodic benefits paid for that period and
- the level annual installment required to amortize over 15 years any lump-sum benefit payments.

Federal regulations (CAS 412.50(c)(3)) state that the cost of a nonqualified defined-benefit pension plan shall be assigned to cost accounting periods in the same manner as qualified plans under the following conditions:

- the contractor, in disclosing or establishing cost accounting practices, elects to have a plan so accounted for;
- the plan is funded through the use of a funding agency; and
- the right to a pension benefit is nonforfeitable and is communicated to the participants.

Federal regulations (CAS 412.50(c)(4)) state that the cost of a nonqualified defined-benefit pension plan must be assigned using the pay-as-you-go method if the plan does not meet all of the above requirements.

FAR 31.201-2(a) further states, in part, that a cost must be reasonable to be allowable. In addition, FAR 31.205-6(b)(2) specifies that comparable market data be used to evaluate the reasonableness of compensation. Furthermore, FAR 31.205-6(p) states: “Costs incurred ... for compensation of a senior executive in excess of the benchmark compensation amount determined applicable for the contractor fiscal year ... are unallowable.” FAR 31.205-6(p)(2)(B) defines senior executives as “the five most highly compensated employees in management positions at each home office and each segment of the contractor, whether or not the home office or segment reports directly to the contractor’s headquarters.”

Additionally, FAR 31.201-6(a) states: “When an unallowable cost is incurred, its directly associated costs are also unallowable.” BRP pension benefits are directly associated with compensation because the benefit is based on the salary history of the recipient.

MEDICARE CONTRACTS

The determination and allocation of pension costs are addressed by the Medicare contract, which states: “The calculation of and accounting for pension costs charged to this agreement/contract

are governed by the Federal Acquisition Regulation and Cost Accounting Standards 412 and 413.” To be allowable for Medicare reimbursement, pension cost must be (1) measured, assigned, and allocated in accordance with CAS 412 and 413 and (2) funded as specified by part 31 of the FAR.

**APPENDIX C: NATIONAL HERITAGE INSURANCE COMPANY STATEMENT
OF ALLOWABLE BENEFIT RESTORATION PLAN COSTS**

Year	BRP Amortized Lump-Sum Benefit Payments	BRP Annuity Benefit Payments	Total Benefit Payments	Medicare Salary Ratio	Medicare CY Allowable Costs	Medicare FY Allowable Costs
	1/	2/	3/	4/	5/	6/
2002	\$13,452	\$3,278,305	\$3,291,757	0.85%	\$27,980	
2003	18,347	3,714,814	3,733,161	0.85%	31,732	\$30,794
2004	28,621	3,759,784	3,788,405	1.05%	39,778	37,767
2005	49,982	4,165,610	4,215,592	1.03%	43,421	42,510
2006	71,791	4,433,567	4,505,358	0.99%	44,603	44,308
2007	78,682	4,794,927	4,873,609	1.14%	55,559	52,820
2008	655,514	6,783,651	7,439,165	1.05%	78,111	72,473
2009	675,902	7,547,293	8,223,195	0.68%	55,918	42,827
Total	\$1,592,291	\$38,477,951	\$40,070,242		\$377,102	\$323,499

ENDNOTES

- 1/ NHIC provided a schedule of lump-sum benefit payments. In accordance with CAS 412.50(b)(3), we amortized the lump-sum benefit payments, including an interest equivalent, over a 15-year period. In computing the interest component for the amortized lump-sum benefit payments, we used the valuation interest rate identified in the qualified defined-benefit plan actuarial valuation reports.
- 2/ NHIC provided a schedule of BRP annuity payments for each CY. In accordance with FAR 31.205-6p, we limited participants' salaries in those calculations to the executive compensation limits.
- 3/ Allocable total benefit payments are the sum of the (i) amortized BRP allocable lump-sum benefit payments and (ii) allocable BRP annuity benefit payments. Total benefit payments differ from the total benefit payments provided to us by NHIC because of the amortization of lump-sum benefit payments.
- 4/ We calculated the Medicare salary ratio based on information provided by NHIC.
- 5/ Medicare CY allowable costs are the total benefit payments multiplied by the Medicare salary ratio.
- 6/ We converted the Medicare CY allowable pension cost to an FY basis (October 1 through September 30). We calculated the FY pension costs as 1/4 of the prior CY's cost plus 3/4 of the current CY's cost. NHIC terminated its Medicare Part B carrier contract on June 1, 2009. Therefore, the 2009 FY pension costs are calculated as 1/4 of the prior CY's cost plus 5/12 of the current CY's cost.

APPENDIX D: AUDITEE COMMENTS



March 7, 2014

Mr. Patrick J. Cogley

Regional Inspector General for Audit Services
Department of Health and Human Services
Office of Inspector General
Office of Audit Services, Region VII
601 East 12th Street, Room 0429
Kansas City, MO 64106

Subject: Audit Report # A-07-14-00435 - National Heritage Insurance Company, Benefit Restoration Plan Costs, FY 2003-2009

Dear Mr. Cogley:

HP has reviewed HHS OIG Audit Report # A-07-14-00435 (National Heritage Insurance Company Claimed Some Unallowable Benefit Restoration Plan Costs for Fiscal Years 2003 Through 2009), dated January 30, 2014 and provides the following in response to the audit findings:

1. **HHS OIG Audit finding: Costs Based on Incorrect Cost Accounting Method**

The Medicare contracts require NHIC to calculate BRP costs in accordance with the FAR and CAS 412 and 413. NHIC's BRP did not satisfy the requirements for accrual accounting as specified in CAS 412.50(c)(3). (See Appendix A). Therefore, NHIC should have accounted for its BRP costs using the pay-as-you-go cost method in accordance with CAS 412.50(b)(3). However, NHIC incorrectly assigned its BRP cost to cost accounting periods using an accrual cost accounting method.

HP Response: HP agrees with this audit finding and will work with CMS on FACP restatements and revisions once this finding has been quantified.

2. **HHS OIG Audit finding: Costs Based on Unreasonable Compensation**

NHIC identified \$45,766,197 as the allocable BRP annuity costs for calendar years (CYs) 2002 through 2009. In our review of benefit payment calculations, we determined that NHIC based its claimed BRP costs, with respect to the annuity payments, on unreasonable compensation. Compensation costs are used in the calculation of allowable BRP costs. We obtained and recalculated 31 benefit payments, using the compensation limits described in FAR 31.205-6(p) (Appendix B), as a benchmark. We calculated the allocable BRP costs for annuities to be \$32,096,879 for the period of CY's 2002 through 2009. Therefore, NHIC overstated the allocable BRP costs for annuities by \$13,669,318 because NHIC did not limit the associated compensation to a reasonable level.

HP Response: HP respectfully disagrees with this audit finding.

A. HP disagrees with several assertions made by HHS OIG regarding "unreasonable" compensation.

- First, HP disagrees with the HHS OIG's position that all compensation in excess of the compensation limits described in FAR 31.205-6(p) is unreasonable since there is no regulation to support the HHS OIG's position. The HHS OIG's FAR citation is limited to the top five executives, yet HHS OIG has erroneously applied that citation to reasonableness of compensation addressed in FAR 31.201-3.

In addition, the HHS OIG appears to have concluded that since some compensation in excess of the legislated executive compensation limit is unallowable (for a very limited number of employees), this implies that all compensation in excess of the legislated executive compensation limit is unreasonable. FAR 31.205-6 (p) addresses compensation costs allowability in terms of legislated limits, not reasonableness of costs, which is addressed in FAR 31.201-3. Although costs that are unreasonable are unallowable, the converse is not true in this instance. Because a cost is made specifically unallowable by the FAR cost principles this does not imply that the cost is unreasonable.

Furthermore, a compensation audit was conducted by the government in 2007 (see enclosed DCAA Audit Report # 3531-2007B13020001) which concluded that EDS/HP's compensation system was adequate to consistently provide reasonable employee compensation costs to Government contracts. The audit report specifically states that the scope of the audit "included the reasonableness of executive compensation." Given this prior compensation audit specifically reviewed executive compensation for reasonableness and that it was conducted in 2007 (i.e. in the middle of the 2003-2009 time period that HHS OIG is currently auditing), HP believes its executive compensation pay and practices were/are reasonable.

- Second, the compensation limits described in FAR 31.205-6(p) are established and published by the Office of Federal Procurement Policy [OFPP]. Although the OFPP benchmark is established based upon a market survey of the compensation practices of other companies, the surveys conducted by OFPP do not meet the guidelines in FAR 31.205-6 (b)(2) and are therefore not valid surveys to be used for determining "reasonableness".

The OFPP benchmark is an amount calculated annually by the Administrator, Office of Federal Procurement Policy. It is established by first conducting a survey of the compensation of executives in US publicly-traded corporations with sales in excess of \$50M. The benchmark is then set equal to the median value from the survey.

FAR 31.205-6 (b)(2) indicates that in determining "reasonableness", compensation can be compared to the compensation practices of companies

"of the same size, in the same industry, in the same geographic area, and engaged in similar non-government work under comparable circumstances". Since the survey used to develop the OFPP Benchmark is not specific to HP and its peers, but rather is a "one-size-fits-all" survey, the OFPP survey does not meet, nor was it ever intended to do meet, the guidelines of FAR 31.205-6 (b)(2). Thus, the use of the OFPP survey data to determine "reasonableness" is not supported by the regulations.

- Third, even if the OFPP survey data were appropriate for use in establishing the "reasonableness" of compensation, HHS OIG has used the survey data in a manner that is statistically invalid. It is not statistically valid to use a median survey value to establish a threshold for "reasonableness". The HHS OIG's position is that any compensation in excess of the OFPP Benchmark amount is unreasonable. As noted above, the OFPP benchmark is set at the median compensation value (50th percentile) of all executives included in the survey. Therefore, when HHS OIG takes the position that all compensation above the OFPP Benchmark is unreasonable, it is thereby asserting that 50% of all executives in the OFPP's survey are being paid unreasonable amounts, a clearly misguided assumption. The use of a median survey value as the basis for determining "reasonableness" is not supported by sound statistical techniques nor by the regulations.

It should also be noted that in a recent case before the ASBCA (Nos. 56105, 56322, January 2012) involving JF Taylor, Inc., DCAA/DCMA took the position that any compensation that exceeded the compensation survey mean value by more than 10% was unreasonable. In ruling against DCAA/DCMA, the ASBCA stated that it found DCAA/DCMA's statistical methodology in the JF Taylor case to be "fatally flawed statistically and therefore unreasonable." Despite the ASBCA's ruling in the JF Taylor case, HHS OIG is now taking an even more statistically-flawed position that all compensation above the survey median value is unreasonable.

Furthermore, in regard to compensation, HP pays its employees reasonable compensation. This is supported by the following:

- HP has a policy for annually reviewing the market competitiveness of its Total Rewards program. As part of this review, HP defines peer groups of companies, obtains and analyzes market data from competitive surveys, and implements appropriate pay grade and/or salary structure adjustments. In addition, HP reviews the compensation of HP's Section 16 officers and compares their compensation to that of HP's peer group companies. Factors considered for setting executive compensation levels include market competitiveness, internal equity and individual performance.

- As stated above, HP has previously been subject to compensation audits by DCAA and these audits have not identified any compensation as being unreasonable. (DCAA Audit Report # 3531-2007B13020001, November 13, 2007). HHS OIG is now asserting that some of HP's compensation costs that occurred as far back as 1998 (16 years ago) are unreasonable, despite the fact that these costs have previously been accepted by the government as reasonable.
- During the 2003-2009 time period, HP conducted approximately 95% of its business in a highly competitive firm fixed price and commercial marketplace. HP would not be financially competitive if it paid compensation amounts that were unreasonably high in comparison to its peers. The FAR 31.201-3 criterion for reasonableness is "(a) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business."

B. HP also disagrees with the HHS OIG's assertion that BRP costs are "directly associated" with compensation costs.

The FAR provision cited [31.201-6(a)] is incomplete and thus applied erroneously. The entire provision states *"(a) Costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. A directly associated cost is any cost that is generated solely as a result of incurring another cost, and that would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly associated costs are also unallowable."* (Emphasis added)

- Even if BRP costs did meet the definition of directly associated, the costs with which they are directly associated have been determined by audit to be allowable. The final sentence of the FAR provision makes it clear that the directly associated costs would only be unallowable if the costs with which it is associated has been deemed to be unallowable.
- Also, Benefits Restoration Plan (BRP) payments to retirees are not generated solely as a result of employee compensation. BRP benefits are accumulated each month by employees over the course of their careers. BRP credits are calculated and built up in employee's BRP accounts based upon numerous factors, which, in addition to compensation, include employee's current age, employee's age on initial hiring date, employee's age on re-hire date, employee's age on July 30, 1998, employee's years of service, employee's post-age-35 years of service, interest rate for the current year, the Social Security wage base for the current year, IRS code 401(a)(17) annual compensation limit for the current year, and employee's EDS Retirement Plan benefit.

Since BRP payments are calculated based upon the numerous factors listed above and are not generated solely as a result of compensation, any assertion that BRP costs are “directly associated” costs is not supported by the regulations.

- C. Finally, HHS OIG also referenced FAR 31.205-6 (p), the senior executive compensation limit. Any assertion that BRP costs are unallowable based upon FAR 31.205-6 (p) is not supported by the regulations in that (1) defined benefit pension plans are not included in the definition of limited compensation, (2) the statutory limitation does not apply to all employees and (3) the costs are not unallowable as directly associated costs.

FAR 31.205-6 (p) (3) Definitions. “As used in this paragraph (p)—(i) Compensation means the total amount of wages, salary, bonuses, deferred compensation (see paragraph (k) of this subsection), and employer contributions to defined contribution pension plans...(ii) Senior executive means—...(B) Effective January 2, 1999, the five most highly compensated employees in management positions at each home office and each segment of the contractor, whether or not the home office or segment reports directly to the contractor’s headquarters.” (Emphasis added)

- Defined benefit pension plans such as the BRP are not included in the FAR 31.205-6 (p) (3) definition of limited compensation. The FAR definition includes “wages, salary, bonuses, deferred compensation (see paragraph (k) of this subsection), and employer contributions to defined contribution pension plans.” Inclusion of the term “defined benefit pension plans” is inappropriate because the term does not actually appear in the text of the regulation. The specific definitional reference to “defined contribution plans” makes it clear that the regulators intended to not include all pension plans, but rather just defined contribution plans and excluding defined benefit plans. (See also the discussion in 3rd bullet of Section C below). Thus, any assertion that defined benefit plan costs are to be included in the compensation that is limited by 31.205-6(p) is contradicted by the regulations.
- The statutory limitation does not apply to all employees. For the time period in question, the FAR terminology includes only “the five most highly compensated employees in management positions.” The HHS OIG position is that this FAR provision applies to all employees. First, it applies only to management positions. Inclusion of other positions is not appropriate. Only recently have Congress and regulation writers drafted laws and regulations that would extend the limitation beyond the management positions. Even these drafts include provision to exempt certain professional and scientific positions for the limitation. Second, the limitation clearly applies only to the top five management positions. Thus, the HHS OIG position to apply the limitation to all employees is contradicted by the regulations.

- The costs are not unallowable as directly associated costs. Generally, a cost that is incurred due only to the incurrence of an unallowable cost is a directly associated cost—and also unallowable. Exceptions are provided for the consideration of materiality and certain other factors. The FAR definition of compensation subject to the limitation specifically included defined contribution pension plan costs as discussed in the first bullet of Section C above. If the regulation writers thought that defined contribution pension plan costs were included in the definition of directly associated costs, there would have been no need to specifically include such costs in the definition. If the regulation writers intended to do so, they would have included defined benefit pension plan costs just as they included defined contribution pension plan costs. Clearly the regulation writers did not intend to treat defined benefit and contribution plans in the same manner—which would result if the term directly associated costs was applied to defined benefit pension plan costs. Thus, the HHS OIG position that these costs are unallowable as directly associated costs is contradicted by the wording in the regulations.

We appreciate the opportunity to review and provide comments on this draft audit report and look forward to working with the HHS OIG to finalize the results of this audit.

We also want to extend our thanks to the HHS OIG audit team for their professionalism and open communication during the review process.

If you have any questions about our response, please do not hesitate to contact me at (703)742-1261 or Mark Shreve at (703)904-8903, or through email at mark.shreve@hp.com.

Sincerely,



Mr. Nicholas Kozar
Director, US Public Sector & Compliance - USFCAL
Hewlett-Packard Company

Cc: Mr. Trace Woodward

Enclosure