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**U.S. OFFICE OF PERSONNEL MANAGEMENT  
OFFICE OF THE INSPECTOR GENERAL  
OFFICE OF AUDITS**

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# Final Audit Report

**AUDIT OF THE FEDERAL EMPLOYEES HEALTH  
BENEFITS PROGRAM OPERATIONS AT  
COVENTRY HEALTH CARE OF KANSAS, INC.**

Report Number 1C-HA-00-15-033

May 10, 2016

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# EXECUTIVE SUMMARY

## *Audit of the Federal Employees Health Benefits Program Operations at Coventry Health Care of Kansas, Inc.*

Report No. 1C-HA-00-15-033

May 10, 2016

### **Why Did We Conduct the Audit?**

The primary objective of the audit was to determine if Coventry Health Care of Kansas (Plan) was in compliance with the provisions of its contract and the provisions of the laws and regulations governing the Federal Employees Health Benefits Program (FEHBP). We verified whether the Plan met the Medical Loss Ratio (MLR) requirements established by the U.S. Office of Personnel Management (OPM). We also verified whether the Plan developed the FEHBP premium rates using complete, accurate and current data.

### **What Did We Audit?**

Under Contract CS 1948, the Office of the Inspector General performed an audit of the FEHBP operations at the Plan. The audit covered the Plan's 2012 and 2013 FEHBP premium rate build-ups and MLR submissions. Our audit fieldwork was conducted from June 15, 2015, through June 26, 2015, at the Plan's office in Blue Bell, Pennsylvania.



**Michael R. Esser**  
*Assistant Inspector General  
for Audits*

### **What Did We Find?**

This report identifies \$121,675 in questioned costs to the FEHBP. Specifically, the Plan underpaid its MLR penalty for contract year 2013.

In the 2012 and 2013 MLR reviews, we found that the Plan did not use a fair and equitable allocation method to derive the federal income tax expense applied to the FEHBP. In addition, the Plan's 2013 MLR claims data was inaccurately submitted to OPM and contained claims paid on annuitants that should have been coordinated with Medicare. As a result, the 2013 FEHBP MLR subsidization penalty account was underpaid by the Plan in the amount of \$121,675. Although there were also findings related to the 2012 MLR calculation, these findings did not result in a penalty for this contract year.

The audit also showed that the rating documentation provided was sufficient to support the 2012 and 2013 FEHBP premium rates

# ABBREVIATIONS

<b>ACA</b>	<b>Affordable Care Act</b>
<b>CFR</b>	<b>Code of Federal Regulations</b>
<b>FEHBAR</b>	<b>Federal Employees Health Benefits Acquisition Regulations</b>
<b>FEHBP</b>	<b>Federal Employees Health Benefits Program</b>
<b>HHS</b>	<b>U.S. Department of Health and Human Services</b>
<b>MLR</b>	<b>Medical Loss Ratio</b>
<b>OIG</b>	<b>Office of the Inspector General</b>
<b>OPM</b>	<b>U.S. Office of Personnel Management</b>
<b>Plan</b>	<b>Coventry Health Care of Kansas, Inc.</b>
<b>SSSG</b>	<b>Similarly-Sized Subscriber Group</b>
<b>TCR</b>	<b>Traditional Community Rating</b>

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# I. BACKGROUND

This final report details the audit results of the Federal Employees Health Benefits Program (FEHBP) operations at Coventry Health Care of Kansas, Inc. (Plan). The audit was conducted pursuant to the provisions of Contract CS 1948; 5 United States Code Chapter 89; and 5 Code of Federal Regulations (CFR) Chapter 1, Part 890. The audit covered contract years 2012 and 2013, and was conducted at the Plan's office in Blue Bell, Pennsylvania.

The FEHBP was established by the Federal Employees Health Benefits Act (Public Law 86-382), enacted on September 28, 1959. The FEHBP was created to provide health insurance benefits for federal employees, annuitants, and dependents, and is administered by the U.S. Office of Personnel Management's (OPM) Healthcare and Insurance Office. The provisions of the Federal Employees Health Benefits Act are implemented by OPM through regulations codified in 5 CFR Chapter 1, Part 890. Health insurance coverage is provided through contracts with health insurance carriers who provide service benefits, indemnity benefits, or comprehensive medical services.

In April 2012, OPM issued a final rule establishing an FEHBP-specific Medical Loss Ratio (MLR) requirement to replace the similarly-sized subscriber group (SSSG) comparison requirement for most community-rated FEHBP carriers (77 FR 19522). MLR is the proportion of FEHBP premiums collected by a carrier that is spent on clinical services and quality health improvements. The MLR for each carrier is calculated by dividing the amount of dollars spent for FEHBP members on clinical services and health care quality improvements by the total amount of FEHBP premiums collected in a calendar year. The MLR is important because it requires health insurers to provide consumers with value for their premium payments by limiting the percentage of premium dollars that can be spent on administrative expenses and profit. For example, an MLR threshold of 85 percent requires carriers to spend 85 cents of every premium dollar on claims and limits the amount that can be spent on administrative expenses and profit to 15 cents of every dollar.

The FEHBP-specific MLR rules are based on the MLR standards established by the Affordable Care Act (ACA, P.L. 111-148) and defined by the U.S. Department of Health and Human Services (HHS) in 45 CFR Part 158. In 2012, community-rated FEHBP carriers could elect to follow the FEHBP-specific MLR requirements, instead of the SSSG requirements. Beginning in 2013, however, the MLR methodology was required for all community-rated carriers, except those that are state-mandated to use traditional community rating (TCR). State-mandated TCR carriers continue to be subject to the SSSG comparison rating methodology.

Starting with the pilot program in 2012 and for all non-TCR FEHBP carriers in 2013, OPM required the carriers to submit an FEHBP-specific MLR. This FEHBP-specific MLR calculation required carriers to report information related to earned premiums and expenditures in various

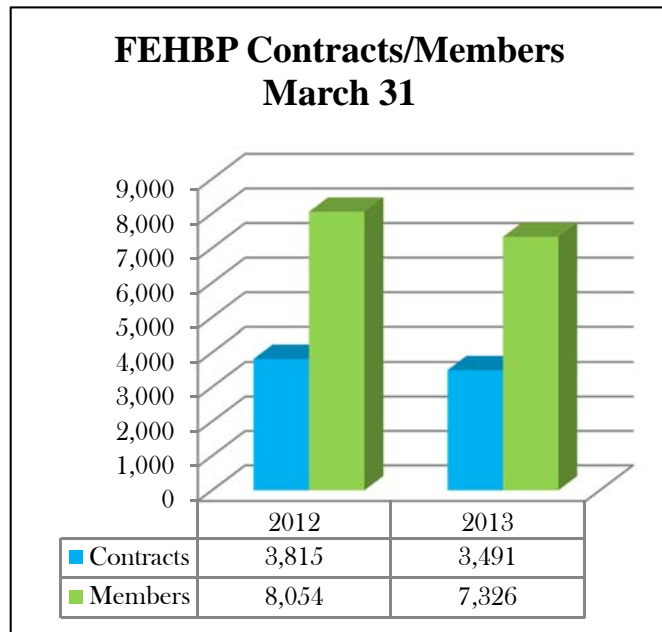
categories, including reimbursement for clinical services provided to enrollees, activities that improve health care quality, and all other non-claims costs. If a carrier fails to meet the FEHBP-specific MLR threshold, it must make a subsidization penalty payment to OPM within 60 days of notification of amounts due.

Community-rated carriers participating in the FEHBP are subject to various Federal, state and local laws, regulations, and ordinances. While most carriers are subject to state jurisdiction, many are further subject to the Health Maintenance Organization Act of 1973 (Public Law 93-222), as amended (i.e., many community-rated carriers are Federally qualified). In addition, participation in the FEHBP subjects the carriers to the Federal Employees Health Benefits Act and implementing regulations promulgated by OPM.

The Plan reported 3,815 contracts and 8,054 members as of March 31, 2012, and 3,491 contracts and 7,326 members as of March 31, 2013, as shown in the chart below.

In contracting with community-rated carriers, OPM relies on carrier compliance with appropriate laws and regulations and, consequently, does not negotiate base rates. OPM negotiations relate primarily to the level of coverage and other unique features of the FEHBP.

The Plan has participated in the FEHBP since 2005 and provides health benefits to FEHBP members in the Kansas City Metropolitan Area (Kansas and Missouri). A prior audit of the Plan covered contract years 2009 and 2010. All findings related to that audit were resolved.



The preliminary results of this audit were discussed with Plan officials at an exit conference and in subsequent correspondence. A draft report was also provided to the Plan for review and comment. The Plan’s comments were considered in preparation of this report and are included, as appropriate, as an Appendix to the report.

## II. OBJECTIVES, SCOPE, AND METHODOLOGY

### Objectives

The primary objective of this performance audit was to determine whether the Plan was in compliance with the provisions of its contract and the laws and regulations governing the FEHBP. Specifically, we verified whether the Plan met the MLR requirements established by OPM and paid the correct amount to the Subsidization Penalty Account, if applicable. Additional tests were also performed to determine whether the Plan was in compliance with the provisions of other applicable laws and regulations.

### Scope

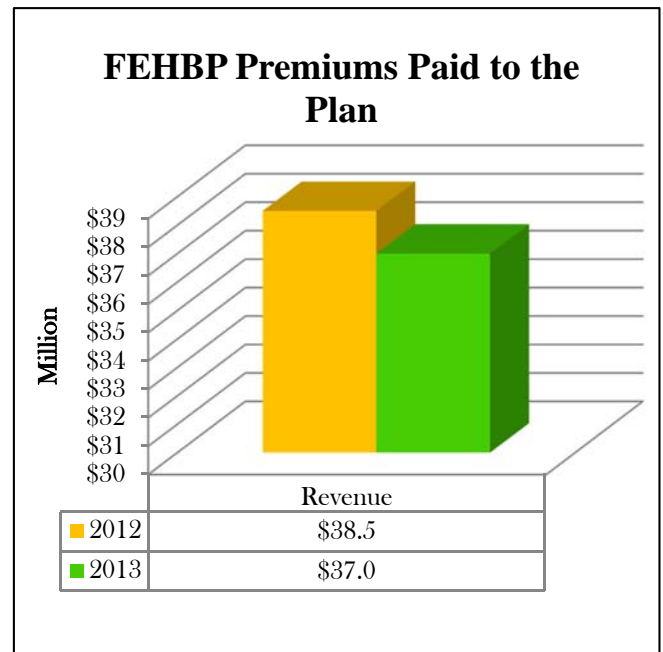
We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.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

This performance audit covered contract years 2012 and 2013. For contract years 2012 and 2013, the FEHBP paid approximately \$38.5 million and \$37 million in premiums to the Plan, respectively.

The Office of the Inspector General's (OIG) audits of community-rated carriers are designed to test carrier compliance with the FEHBP contract, applicable laws and regulations, and the rate instructions. These audits are also designed to provide reasonable assurance of detecting errors, irregularities, and illegal acts.

We obtained an understanding of the Plan's internal control structure, but we did not use this information to determine the nature, timing, and extent of our audit procedures. However, the audit included such tests of the Plan's rating system and such other auditing procedures considered necessary under the circumstances. Our review of internal controls was limited to the procedures the Plan has in place to ensure that:

- The rates charged to the FEHBP were developed in accordance with the Plan's standard rating methodology and the claims, factors, trends, and other related adjustments were supported by complete, accurate, and current source documentation; and





- The FEHBP MLR calculations were accurate, complete, and valid; claims were processed accurately; appropriate allocation methods were used; and, that any other costs associated with its MLR calculation were appropriate.

In conducting the audit, we relied to varying degrees on computer-generated billing, enrollment, and claims data provided by the Plan. We did not verify the reliability of the data generated by the various information systems involved. However, nothing came to our attention during our audit utilizing the computer-generated data to cause us to doubt its reliability. We believe that the available data was sufficient to achieve our audit objectives. Except as noted above, the audit was conducted in accordance with generally accepted government auditing standards, issued by the Comptroller General of the United States.

The audit fieldwork was performed from June 15, 2015, through June 26, 2015, at the Plan’s office in Blue Bell, Pennsylvania.

**Methodology**

We examined the Plan’s MLR calculations and related documents as a basis for validating the MLR. Further, we examined claim payments and quality health expenses to verify that the cost data used to develop the MLR was accurate, complete, and valid. We also examined the methodology used by the Plan in determining the premium in the MLR calculations. Finally, we used the contract, the Federal Employees Health Benefits Acquisition Regulations (FEHBAR), and the rate instructions to determine the propriety of the Plan’s MLR calculations.

To gain an understanding of the internal controls in the Plan’s claims processing system, we reviewed the Plan’s claims processing policies and procedures and interviewed appropriate Plan officials regarding the controls in place to ensure that claims were processed accurately. Other auditing procedures were performed as necessary to meet our audit objectives.

The tests performed, along with the methodology, are detailed below:

**Medical Claims Sample Selection Criteria/Methodology**

Medical Claims Review Area	Universe Criteria	Universe (Number)	Universe (Dollars)	Sample Criteria and Size	Sample Type	Results Projected to the Universe?
Coordination of Benefits (COB) Medicare 2012	All Medical claims for contract year 2012	██████	\$██████	Selected all medical claims greater than or equal to \$██████ for members age 65 or older, resulting in 15 claims totaling \$██████	Judgmental	No



Medical Claims Review Area	Universe Criteria	Universe (Number)	Universe (Dollars)	Sample Criteria and Size	Sample Type	Results Projected to the Universe?
Coordination of Benefits (COB) Medicare 2013	All Medical claims for contract year 2013	██████	\$██████	Selected all medical claims greater than or equal to \$██████ for members age 65 or older, resulting in 18 claims totaling \$██████	Judgmental	No
System Discount Review 2012	All Medical claims for contract year 2012	██████	\$██████	Selected all claims greater than or equal to \$██████ plus 33 random claims selected by paid group dollar strata and place of service, resulting in 50 claims totaling \$██████	Judgmental and Random	No
System Discount Review 2013	All Medical claims for contract year 2013	██████	\$██████	Selected all claims greater than or equal to \$100,000 plus 28 random claims selected by paid group dollar strata and place of service, resulting in 50 claims totaling \$██████	Judgmental and Random	No

We also examined the rate build-up of the Plan's 2012 and 2013 Federal rate submissions and related documents as a basis for validating the Plan's standard rating methodology. We verified that the factors, trends, and other related adjustments used to determine the FEHBP premium rate(s) were sufficiently supported by source documentation. Further, we examined claim payments to verify that the cost data used to develop the FEHBP rates was accurate, complete, and valid. Finally, we used the contract, the FEHBP, and the rate instructions to determine the propriety of the FEHBP premiums and the reasonableness and acceptability of the Plan's rating system.

In addition, we examined the Plan's financial information and evaluated the Plan's financial condition and ability to continue operations as a viable ongoing business concern.

# III. AUDIT FINDINGS AND RECOMMENDATIONS

## 1. Medical Loss Ratio Penalty Underpayment

\$121,675

Coventry Health Care of Kansas, Inc. (Plan) elected to participate in the 2012 Medical Loss Ratio (MLR) pilot program offered to certain Federal Employees Health Benefits Program (FEHBP) carriers. The MLR pilot program replaced Similarly-Sized Subscriber Group requirements with an MLR threshold. Simply stated, the MLR is the ratio of FEHBP incurred claims (including expenses for health care quality improvement) to total premium revenue determined by the U.S. Office of Personnel Management (OPM).

For contract year 2012, the OPM-established MLR threshold for MLR pilot program carriers was 89 percent. Therefore, 89 cents of every health care premium dollar must have been spent on health care expenses. If the MLR was less than 89 percent, a carrier will owe a subsidization penalty equal to the difference between the threshold and the carrier's actual MLR.

For contract year 2013, OPM changed the MLR threshold to 85 percent and created an MLR corridor. If carriers met the MLR threshold, no penalty is due. If the MLR was over 89 percent, the carrier receives a credit equal to the difference between the carrier's reported MLR and 89 percent, multiplied by the denominator of the MLR. This credit can be used to offset any future MLR penalty and is available until it is used up by the Plan or the Plan exits the FEHBP.

The Plan calculated an MLR of [REDACTED] percent for contract year 2012, and [REDACTED] percent for contract year 2013. However, during our review of the Plan's MLR submissions, we found the following issues.

### Tax Allocation

Pursuant to the provision of U.S. Department of Health and Human Services (HHS) 45 Code of Federal Regulations (CFR) § 158, Plans are allowed to reduce the premium used in the MLR calculation by taxes and regulatory fees paid, excluding Federal income taxes paid on investment income and capital gains. The Plan allocated non-income related taxes, regulatory fees, quality health improvement expenses, and fraud reduction expenses that were applicable to the FEHBP by using a premium ratio allocation method. The premium ratio was calculated by dividing the FEHBP premium by the total large group sector premium on the HHS MLR filing, of which the FEHBP is included. However, for Federal income taxes, the Plan attempted to calculate the gain or loss on the FEHBP as if it was its

own entity. The result was a Federal income tax allocation of (\$ [REDACTED]) and \$ [REDACTED] to the FEHBP for contract years 2012 and 2013, respectively.

HHS 45 CFR § 158.170 requires that the Plan's allocation method be based on a generally accepted accounting method. However, we found that the Plan's method used to allocate the Federal income taxes to the FEHBP is not applied proportionately, appropriately, and is not based on a generally accepted accounting method. Also, it is not suitable to treat the FEHBP as if it were its own entity since expenses are not tracked at the group level and the method is not related to actual expenses incurred. A more appropriate method, which the Plan used for several other expenses in its MLR calculations, is the premium ratio allocation method. This method yields a more accurate result and is supportable. Therefore, we recalculated the Federal income tax allocation using the premium ratio method and determined that the FEHBP's portion of Federal income tax is \$ [REDACTED] and \$ [REDACTED] for contract years 2012 and 2013, respectively. As a result, we reduced the premium in our audited MLR calculations by \$ [REDACTED] and \$ [REDACTED].

**Plan Response:**

*The Plan disagrees with the OIG's Federal income tax allocation in the 2012 and 2013 MLR calculations. The Plan contends that their methodology of calculating the FEHBP net income and applying the applicable tax rate is a more accurate representation of the FEHBP federal income tax expense. The Plan states that net income, not premium, should be used to allocate income taxes since income and losses are what determines the tax expense. Additionally, the Plan maintains that its income tax allocation method for the FEHBP conforms to generally accepted accounting principles. Finally, it asserts that the method used for its FEHBP Federal income tax allocation is the same method used for its HHS MLR filing.*

**OIG Comment:**

The OIG disagrees with the Plan and asserts that the Plan's method used to calculate the FEHBP Federal income tax does not conform to the HHS 45 CFR § 158, which states, "All costs reported by issuers must be *allocated* according to generally accepted accounting methods that yield the most accurate results and are well documented." The Plan did not allocate a portion of the Federal income tax expense that was reported on the Plan's statutory financial statements, but instead calculated an FEHBP net income value that is not well documented. Ultimately, the Plan's FEHBP net income calculation is unverifiable and is not an equitable basis to determine the FEHBP Federal income tax expense.

The HHS regulations require a portion of taxes be allocated to each of the MLR health insurance markets (e.g., individual, small group, large group, etc.), which the Plan refers to as

MLR pools. To determine each pool's Federal income tax amount, including that of the HHS large group pool, the Plan calculated the net income for the large group pool, divided by the net income for the entire company and multiplied by the Federal income taxes reported on the annual statement. This methodology adheres to the HHS regulation by allocating a portion of the Federal income taxes reported by the Plan on their statutory financial statements.

However, the Plan did not consistently use this method to determine the Federal income tax attributable to the FEHBP, which is part of the HHS large group pool. Instead of allocating a portion of the reported Federal income tax to the FEHBP as required by HHS 45 CFR § 158, the Plan calculated the FEHBP net income and multiplied the amount by a corporate tax rate of 35 percent. This method is inconsistent with the Plan's Federal income tax allocation for the HHS MLR pools and not well documented since the FEHBP's net income cannot be verified.

The Plan's removal of expenses in the FEHBP net income calculation also distorts the expenses reported for the HHS large group pool. Since the FEHBP is part of the large group sector, those expenses should be removed from the large group net income calculation as well. If they are not removed, then the expenses are spread out amongst the rest of the large group sector which will understate the amount of taxes allocated to the large group pool. Since the Plan cannot track expenses on a group level, contractual exclusions or variances in contractual expenses cannot be accurately tracked, rendering it impossible to determine any one group's net income.

Consequently, it is our position that the premium ratio allocation method yields a more accurate result to determine the FEHBP Federal income tax expense, since it adheres to the HHS regulation and was used by the Plan in several other MLR cost allocation areas. Therefore, we recalculated the Federal income tax allocation using the premium ratio method and determined that the FEHBP's portion of Federal income tax is \$ [REDACTED] and \$ [REDACTED] for contract years 2012 and 2013, respectively. As stated above, we reduced the premium in our audited MLR calculations by \$ [REDACTED] and \$ [REDACTED].

### **MLR Claims Data**

During our review of the Plan's MLR submission for contract year 2013, we determined that the incurred claims amount included in the MLR calculations was incorrect for pharmacy claims, capitation, dental claims, and pharmacy rebates. The Plan provided updated, corrected claims figures for each of these categories which were used in the audited review of the Plan's MLR calculation.

In addition, we reviewed 50 system medical claims for the 2013 contract year and determined that 2 of these claims were incorrectly coordinated with Medicare, resulting in an overpayment of \$ [REDACTED]. As a result, we removed \$ [REDACTED] from the incurred claims in our audited MLR calculation.

We updated our audited MLR calculation to reflect the corrected 2013 pharmacy claims, capitation amounts, dental claims and pharmacy rebates, as well as the removal of the two claims that were not coordinated with Medicare. As a result, the numerator of the audited 2013 MLR calculation was reduced by \$ [REDACTED].

**Plan Response:**

*The Plan agrees with the MLR claims findings related to the incorrectly coordinated Medicare claims and has updated their calculation of the 2013 OPM MLR rebate accordingly.*

**Conclusion**

We recalculated the Plan's 2012 and 2013 MLR submissions with the adjusted federal income tax expense, allocated on a premium ratio basis. Additionally, we updated our audited MLR calculations to reflect the corrected 2013 pharmacy claims, capitation amounts, dental claims and pharmacy rebates, as well as the removal of the two claims that were not coordinated with Medicare. The audited MLR calculation for contract year 2012 resulted in no underpayment of the MLR subsidization penalty. However, the audited MLR calculation for contract year 2013 resulted in an MLR subsidization penalty underpayment computation of \$121,675 (see Exhibit B).

**Recommendation 1**

We recommend that the contracting officer require the Plan to return \$121,675 to the MLR subsidization penalty account for contract year 2013.

**Recommendation 2**

We recommend that the contracting officer require the Plan to implement proper system edits to properly coordinate the payment of claims with Medicare.

**Recommendation 3**

We recommend that the contracting officer require the Plan to submit accurate and valid claims data per the criteria issued yearly in the FEHBP Program Carrier Letter entitled Claims Data Requirements for Non-Traditional Community-Rated Carriers.

# IV. MAJOR CONTRIBUTORS TO THIS REPORT

## COMMUNITY-RATED AUDITS GROUP

██████████, Auditor-in-Charge

██████████

██████████

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██████████, Senior Team Leader

██████████, Group Chief



# EXHIBIT A

## Coventry Health Care of Kansas, Inc. Summary of Medical Loss Ratio Penalty Underpayment

### Contract Year 2013

Medical Loss Ratio Penalty	<u>\$121,675</u>
Total Penalty Due OPM	<u>\$121,675</u>

# EXHIBIT B

## Coventry Health Care of Kansas, Inc. 2013 Medical Loss Ratio Penalty Underpayment

	Plan	Audited
2013 FEHBP MLR Lower Threshold (a)	85%	85%
2013 FEHBP MLR Upper Threshold (b)	89%	89%
<b><u>Claims Expense</u></b>		
Adjusted Incurred Claims	\$ [REDACTED]	\$ [REDACTED]
Expenses to Improve Health Care Quality	\$ [REDACTED]	\$ [REDACTED]
<b>Total Adjusted Incurred Claims</b>	<b>\$ [REDACTED]</b>	<b>\$ [REDACTED]</b>
<b><u>Premiums</u></b>		
Premium Income	\$37,467,061	\$37,467,061
Less: Federal and State Taxes and Licensing or Regulatory Fees	\$ [REDACTED]	\$ [REDACTED]
<b>Adjusted Premium</b>	<b>\$ [REDACTED]</b>	<b>\$ [REDACTED]</b>
Less: Defective Pricing Finding (Due OPM)	\$ [REDACTED]	\$ [REDACTED]
<b>Total Adjusted Premium (c)</b>	<b>\$ [REDACTED]</b>	<b>\$ [REDACTED]</b>
Total Adjusted Incurred Claims (MLR Numerator)	\$ [REDACTED]	\$ [REDACTED]
Total Adjusted Premium less Defective Pricing (MLR Denominator)	\$ [REDACTED]	\$ [REDACTED]
FEHBP MLR Calculation (d)	[REDACTED] %	[REDACTED] %
Penalty Calculation (If (d) is less than (a), ((a-d)*c)	\$ [REDACTED]	\$ [REDACTED]
Credit Calculation (If (d) is greater than (b), ((d-b)*c)	\$ [REDACTED]	\$ [REDACTED]
<b>Total Penalty Due OPM</b>		<b>\$121,675</b>

# APPENDIX

**aetna**<sup>®</sup>

980 Jolly Road, Blue Bell, PA 19422

[REDACTED]  
Executive Director  
FEHBP Underwriting  
Tel: [REDACTED]  
Email: [REDACTED]@aetna.com

January 15, 2016

[REDACTED]  
Chief, Community-Rated Audits Group  
U.S. Office of Personnel Management  
Office of the Inspector General  
1900 E Street NW, Room 6400  
Washington, DC 20415

Re: Audit of Coventry Health Care of Kansas, Inc  
Contract Number CS 1948 – Plan Code HA & 9H  
Report No. 1C-HA-00-15-033

Dear [REDACTED]:

Thank you for the opportunity to respond to the draft audit report dated November 19, 2015. After careful review of the draft report, we agree with the draft report's findings on the medical claims that were paid incorrectly due to coordination with Medicare under the MLR Claims Data section of the report. However, we respectfully disagree with the OIG's findings that the Coventry Health Care of Kansas, Inc's method to determine the portion of federal income taxes attributed to the FEHBP was not fair and equitable for purposes of calculating the 2012 and 2013 Minimum Loss Ratio. We believe that Coventry Health Care of Kansas, Inc's calculation of federal income taxes was consistent with the standard required in the MLR regulations and accordingly the subsidization penalty in the draft report is overstated.

Please see the attached analysis in support of Coventry Health Care of Kansas, Inc's position. If you have any questions as you review our response, please contact me.

Report No. 1C-HA-00-15-033

Sincerely,

[REDACTED]

[REDACTED]

Executive Director

cc: Alan Spielman  
Assistant Director for Federal Employees Insurance Operations, OPM

Lloyd Williams  
Deputy Assistant Director for Federal Employees Insurance Operations, OPM

[REDACTED]  
Chief, Health Insurance Group III, OPM

[REDACTED]  
Actuaries group, OPM

[REDACTED]  
Chief, Audit Resolution, OPM

[REDACTED]  
President, Federal Plans, Aetna

**Response to Draft Report dated November 19, 2015**

**Audit of Coventry Health Care of Kansas, Inc.  
Blue Bell, Pennsylvania**

**Report No. 1C-HA-00-15-033**

## I. Introduction/Executive Summary

Coventry Health Care of Kansas submits the following comments to the above mentioned draft report (“Draft Report”) issued by the Office of Personnel Management (“OPM”) Office of Inspector General (“OIG”) under the Federal Employees Health Benefits Program (“FEHBP”). The audit covered the FEHBP contract for the Coventry Health Care of Kansas, Inc. Plan Code HA & 9H, (hereinafter, the “Plan”) for the contract years 2012 and 2013 Medical Loss Ratio (“MLR”) program.

The Draft Report found that the Plan underpaid its 2013 MLR subsidization **DELETED BY OIG – NOT RELEVANT FOR FINAL REPORT** The Plan agrees with the Draft Report’s findings on the medical claims that were paid incorrectly due to coordination with Medicare.

The Plan respectfully disagrees with the finding pertaining to the tax allocation methodology. Specifically, the Plan disagrees with OIG’s use of the premium ratio allocation method to determine the FEHBP’s portion of federal income tax. The federal MLR regulations at 45 C.F.R. §158.170 require that the tax allocation method be based upon a generally accepted accounting method (“GAAM”) that is expected to yield the most accurate results. The Plan believes its calculation is correct and meets the standards set under a GAAM and therefore satisfies the requirements of 45 C.F.R. § 158.170. In this response, the Plan demonstrates through a detailed explanation that the method the Plan used to allocate Federal income tax provides the most accurate results, and is consistent with the method used to calculate the Department of Health and Human Services (“HHS”) MLR filings.

## II. Medical Loss Ratio Background

The Affordable Care Act (“ACA”) passed in 2010 included a requirement that a minimum amount of premiums collected by health insurance carriers must be spent on medical benefits. This requirement became known as the MLR and requires health insurance carriers to meet a predetermined threshold for the percentage of premium that is spent on medical benefits. Failure to meet the threshold requires a rebate of premium to policyholders.

The MLR is calculated as total claims paid divided by premiums. However, the ACA allows for certain adjustments to both the claim and premium numbers in the ratio. Claims include medical benefits paid on behalf of members and are adjusted by the cost of health care quality improvement activities (“QIA”). Premiums include premium revenue from members and plan sponsors and are adjusted by federal and state taxes, and licensing and regulatory fees.

In 2012, OPM adopted an MLR requirement for the FEHBP on a pilot basis and the Plan elected to participate in the pilot. See 77 Fed. Reg. 19522 (April 2, 2012). OPM

published MLR regulations and other guidance that generally adopts the HHS MLR guidelines in addition to a few requirements specific to the FEHBP MLR program.

### **III. Tax Allocations and Generally Accepted Accounting Method**

#### **a. Background**

The amount of federal taxes to be used as an adjustment to premiums is the amount allocated to health insurance coverage reported on the MLR form. A health insurer pays federal taxes on all of its business net income on a combined basis. Consequently, the amount of federal income tax related to health insurance coverage reported on the MLR form must be allocated. The ACA did not include specific rules for calculating MLR. Rather, HHS was directed to establish detailed rules by regulation. HHS promulgated regulations in 2010 and 2011 that contain detailed rules, including the method to allocate expenses in the MLR calculation. 75 Fed. Reg. 74864 (Dec. 1, 2010) as amended by 76 Fed. Reg. 76574 (Dec. 7, 2011).

The applicable regulation states in part, “[a]llocation to each category should be based on a generally accepted accounting method that is expected to yield the most accurate results.” and “[a]ny basis adopted to apportion expenses must be that which is expected to yield the most accurate results and may result from special studies of employee activities, salary ratios, premium ratios or similar analyses.” (see 45 C.F.R. §§ 158.170(b)(1) and (3)).

#### **b. Coventry Health Care of Kansas, Inc. Income Tax Allocations**

The Plan adopted a method to allocate federal income tax that is based upon the net income or loss generated by the “reporting unit.” With respect to the HHS MLR filing, the “reporting unit” is the MLR segment and contract situs or location (“MLR Pool”) as outlined in the HHS filing form. For the FEHBP MLR filing, the “reporting unit” is the Plan Code that is included in the FEHBP MLR filing form. With respect to federal income tax returns, the “reporting unit” is the legal entity.

Allocated income tax can be either an expense or a refund depending on whether a reporting unit experiences net income or loss. For the HHS and FEHBP MLR tax allocations, Aetna/Coventry allocates income tax expense to reporting units with net income and an income tax refund to reporting units with a net loss. This allocation is consistent with Generally Accepted Accounting Principles (“GAAP”) as promulgated by the Financial Accounting Standards Board and with Statutory Accounting Principles (“SAP”) as promulgated by the National Association of Insurance Commissioners. In fact, the MLR calculation for income taxes instructs the use of SAP as the accounting standard for such taxes.

The income tax allocation method that Coventry Health Care of Kansas, Inc. uses for the FEHBP MLR reporting and HHS MLR reporting is consistent with the United States (“US”) accounting principles explained above. The only difference between Coventry’s HHS MLR reporting and FEHBP MLR reporting is that the HHS form includes all the MLR



Pools in a legal entity. The FEHBP MLR form includes only the reported Plan Code activity and that Plan Code may include more than one legal entity. Therefore, Aetna/Coventry allocates general and administrative expenses along with the Plan Code's premiums and incurred claims in order to determine the net income or loss from the Plan Code. The final step is the allocation of income tax expense or refund to the Plan Code using the tax rate applicable to the net income or loss in Aetna/Coventry's income tax returns.

Unlike income taxes, non-income taxes, such as employment taxes and QIA expenses, are not based on income. Therefore, these specific items are allocated based on the premium ratio allocation method used by the Plan, with which the Draft Report agrees.

#### **IV. OIG Tax Allocation Audit Findings**

The Draft Report contains a preliminary finding that the Plan did not use a fair and equitable allocation method to determine the portion of Federal income taxes attributed to the FEHBP and identifies a draft MLR penalty underpayment for contract year 2013 **DELETED BY OIG – NOT RELEVANT FOR FINAL REPORT.** According to the Draft Report, the premium ratio allocation method that the Plan used for non-income tax expenses and QIA is also the appropriate method for income tax expense.

#### **DELETED BY OIG – NOT RELEVANT FOR FINAL REPORT**

The Plan respectfully disagrees that the premium ratio allocation method is an appropriate method to allocate income taxes as there is no conceptual basis in applicable US accounting standards for income taxes to be determined based solely on premium. It is net income or loss that generates income tax expense and refunds under US tax laws and regulations, as well as US accounting principles. Relying solely on premiums produces inaccurate results as this method ignores a fundamental accounting principle that income taxes are determined on net income or loss.

##### **a. Coventry Health Care of Kansas, Inc. FEHBP Tax Allocation not proportionate, appropriate or a GAAM**

The Draft Report states, "the Plan's method used to allocate the Federal income taxes to the FEHBP is not applied proportionately, appropriately, and is not based on a generally accepted accounting method."

As discussed previously in this response, the Plan asserts that with respect to allocating income taxes, a GAAM must account for income net of expenses (i.e., net income or loss) in order to be appropriate and yield an accurate result. The Plan's tax allocation method is appropriate as Plan Codes reporting net loss are allocated a proportionate income tax refund and Plan Codes reporting net income are allocated a proportionate income tax expense.

This allocation method is consistent with the HHS MLR tax allocations that allocate a proportionate income tax refund to MLR Pools reporting net losses and income tax expense to MLR Pools reporting net income.

The Plan's income tax allocation method is a GAAM and conforms with GAAP and SAP accounting principles that produce income tax expense for reporting units with net income and income tax refund for reporting units with net losses.

**b. Coventry Health Care of Kansas, Inc. FEHBP Tax Allocation treats FEHBP Plan Code as a legal entity**

The Draft Report states, "it is not suitable to treat the FEHBP as if it were its own entity since expenses are not tracked at the group level and the method is not related to actual expenses incurred. A more appropriate method, which the Plan used for several other expenses in its MLR calculation, is the premium ratio allocation method."

The Plan did not treat the Plan Code as if it were its own legal entity. Rather, the Plan simply computed the net income or loss attributable to the Plan Code, as that is the reporting unit required to file the FEHBP MLR form. This computation included the actual premiums and claims associated with the Plan Code and associated expenses allocated to the Plan Code.

**1. Allocation of expenses to determine Plan's net income or loss.**

The Plan applied the following premium ratio to allocate non-income tax expenses and other non-tax expenses to determine the Plan's net income or loss:

Coventry Health Care of Kansas, Inc Plan Code Premium

Legal Entity Premium for all HHS Large Group Pools

Since the Plan Code was included in the HHS Large Group pools, this ratio is a GAAM that yields the most accurate allocation of non-income tax expenses and other non-tax expenses such as QIA.

With respect to the FEHBP, this allocation was used only for those expenses that are applicable to the FEHBP business. For instance, the Plan's expense allocation specifically excluded state premium tax expense and broker commissions since FEHBP premiums are exempt from state premium tax and the FEHBP does not use brokers.

**2. Income tax expense or refund allocated based on net income**

As discussed above, income tax expense or refunds are fundamentally different from non-income tax or other non-tax expenses because they are based upon the net income or loss of the reporting unit. Therefore, it is necessary to determine net income or loss in order to appropriately allocate income taxes to the Plan Code.

The Plan's method to allocate income tax expense or refund applies the non-income tax and non-tax expense allocation method discussed in the section above to determine the net income or loss from the Plan Code and then uses this result to allocate income tax expense or refund to the Plan Code. This is not an attempt to treat

the Plan Code as if it were its own legal entity, but necessary to determine the appropriate income tax expense or refund to allocate to the Plan Code.

Coventry Health Care of Kansas, Inc. does not allocate income tax expense or refund on the HHS MLR filings using a premium ratio used for non-income taxes because a premium ratio would not be a GAAM that yields the most accurate result. The same method is necessary for the FEHBP MLR filing; the income tax allocation method must be different from the allocation method for non-income tax and other non-tax expenses in order to be a GAAM. If a premium ratio is used to allocate income tax, the same amount of income tax would be allocated to two Plan Codes with the same premium income even though one incurred significantly higher claims. Please reference the examples in the Plan's response to Draft Report of Aetna HealthFund, Report No. 1C-22-00-14-071. Example 1 in the report illustrates how two hypothetical plan codes (Ohio and Texas) are allocated the same income tax expense under this method even though they incurred higher claims. That result is inconsistent with US accounting principles and is not the most accurate allocation method as required by the HHS MLR regulations.

## **V. Coventry Health Care of Kansas, Inc. Income Tax Allocation Method**

The Plan's method to allocate income tax expense or refund is based upon the net income or loss associated with the Plan Code for the year. The Plan Code's income tax allocation is the final allocation performed after calculating the Plan Code's net income. All applicable expenses other than income taxes are allocated to the Plan Code using a gross premium percentage ratio that is calculated by dividing the Plan Code's premium by the premium for all large group pools. The Plan Code's claims and these allocated expenses are deducted from the Plan Code's gross premium to generate the net income or loss per Plan Code. Then the income tax is allocated by multiplying the Plan Code net income or loss by the applicable tax rate. This produces an income tax expense for Plan Codes that generate net income or an income tax refund for Plan Codes that generate net losses.

The Draft Report method differs from the Plan's method in that it utilizes the gross premium ratio, used to allocate expenses other than income tax, to allocate the total income tax expense or refund for all large group pools. This method does not account for the fact that some Plan Codes generate net income and others generate a net loss.

Please reference the examples in the Plan's response to the Draft Report of Aetna HealthFund, Report No. 1C-22-00-14-071, which demonstrate why the Plan's method is proportionate, consistent and accurate. These standards establish that the Plan's method is a GAAM that yields the most accurate results.

## **VI. Coventry Health Care of Kansas, Inc. Response to Other OIG Findings**

Medical Claims Paid Incorrectly Based on Coordination with Medicare – The Plan agrees with the Draft Report’s finding of \$ [REDACTED] and has applied this adjustment into the updated MLR calculation at the end of this response.

The Plan is currently researching Recommendation 4 and will schedule time with OIG to discuss the next steps once more information is available.

## **VII. Conclusion**

As explained above and demonstrated in the examples referenced, the Plan’s income tax allocation method is a GAAM that yields the most accurate result. That is, the Plan’s method produces consistent results when the Plan Code results are the same, and is not impacted by changes resulting from other activity occurring within the legal entity. An allocation method that produces a different result when the activity of other business or Plan Codes change cannot be considered a GAAM that yields the most accurate result.

The Plan has updated the MLR calculation to account for all adjustments made during the onsite portion of the audit and to remove the \$ [REDACTED] in medical claims incorrectly paid due to coordination with Medicare. The updated MLR calculation results in the Plan meeting the 85% MLR threshold for 2013 and thus no penalty is owed to the FEHBP.

# Revised Penalty Calculation

Coventry Health Care of Kansas,  
Inc  
MLR Questioned Costs  
Contract year 2013

**DELETED  
BY OIG –  
NOT  
RELEVANT  
FOR FINAL  
REPORT**

Contract Year 2013	Plan - Draft Report Response		Plan - Original
Target MLR Ratio	85%		85%
Adjusted Incurred Claims	\$ [REDACTED]		\$ [REDACTED]
Quality Health Improvement Expenses	\$ [REDACTED]		\$ [REDACTED]
<b>MLR Numerator</b>	\$ [REDACTED]		\$ [REDACTED]
Premium Income	\$37,467,061		\$37,467,061
Federal and State Taxes and Licensing or Regulatory Fees	\$ [REDACTED]		\$ [REDACTED]
Less: RBA Finding(s)	\$ [REDACTED]		\$ [REDACTED]
<b>MLR Denominator</b>	\$ [REDACTED]		\$ [REDACTED]
<b>FEHBP MLR Calculation</b>	[REDACTED] %		[REDACTED] %
<b>Penalty Due to OPM</b>	\$ [REDACTED]		\$ [REDACTED]
<b>Total Questioned Cost</b>	<b>\$0</b>		<b>\$0</b>



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