

DEPARTMENTAL GRANT APPEALS BOARD

Department of Health and Human Services

SUBJECT: California Department of Health Services - DATE: May 29, 1981  
San Joaquin Foundation  
Docket No. 79-147-CA-HC  
Decision No. 182

DECISION

The California Department of Health Services appealed from a disallowance by the Health Care Financing Administration (Agency) of \$331,475 1/ in Federal financial participation (FFP) claimed by the State for payments to the San Joaquin Foundation for Medical Care (Foundation), under contract with the State as a prepaid health plan provider pursuant to Title XIX of the Social Security Act. The costs were incurred during the period August 1, 1970 through March 31, 1972. With the concurrence of the State, the Board granted the Foundation's request to participate in this appeal as a party.

The disallowance was based on HEW (now HHS) Audit Agency Report ACN 30013-09. The State originally disputed the findings of the HEW audit based on a subsequent State audit. During litigation between the State and the Foundation, the State performed another audit, which also was a basis for disputing the HEW findings. The Agency's reconsideration in this case was delayed during preparation of the second State audit.

The record in this appeal consists of the State's application for review, the Agency's response, the Record of Reconsideration (SRS Docket No. ME-CA7401), six State exhibits, six Agency exhibits (seven were marked but the Agency withdrew one), and the transcript of the hearing held on March 26, 1981. There was no post-hearing briefing. At the hearing, the parties stipulated to introduction of a State-prepared summary of contested findings and amounts in dispute (see State Exhibit 1, Introduction, p. 4; Transcript, p. 6), which we use here as a basis for the computations in our determination.

The Audit involved a number of different findings and issues. Our decision deals with the various elements of the disallowance separately, under the headings below.

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1/ Because of an Agency computation error, this amount should be \$331,484. See discussion in footnote 5 below.

"Partial Month Eligibles"

Of the contested disallowed amounts, \$176,950 (of which the Federal share was \$88,475) represents alleged overpayments by the State to the Foundation for benefits for recipients who fall under the parties' rubric of "partial month eligibles" (State Exhibit 1, Introduction, p. 4; Transcript, p. 3). The term covers both persons who were only eligible for benefits for a portion of a month and persons who were retroactively determined to be eligible and for whom the rolls were later adjusted (Record of Reconsideration ("RR"), Tab 3, p. 20). The HEW auditors determined that the Foundation overstated the number of these recipients by 21,685 for the period August 1, 1970 through September 30, 1971 (id). The auditors found that:

Foundation records showed that an increase of 40,502 count was reported to [the State] during the period August 1, 1970 through September 30, 1971. Based on the Caseload Movement and Expenditure Reports (Form CA-237) for the above period, we determined that the increases due to new applications, restorations and transfers totaled only 18,817 rather than 40,502, or a difference of 21,685. Based on this, the overpayment totals \$176,950 (21,685 count times \$8.16 average cost). Id., pp. 20-21.

In the 1973 State audit, the State's auditors arrived at a disallowance of \$185,737, which cannot be usefully compared to the Federal figure because the State amount related to a substantially different time period and overlapped on one or more items which the HEW audit treated separately. 2/ Later, as a result of the 1978 State audit, the State discounted both the earlier State and HEW audit results, and concluded that the State actually owed the Foundation \$225,932; but this finding, too,

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2/ This audit was for the period July 1, 1969, through September 31, 1972, a period which included, but was more than three times as long as, the period of the HEW audit for this disallowed item. Further, the State auditors included in the \$185,737 the sum of \$33,079 attributable to duplicate recipient counts, which the HEW auditors separately questioned (RR, Tab 3, p. 18; Tab 35, p. 10). Differences are also attributed to unspecified "varying audit procedures" (RR, Tab 4, and Tab 21, p. 2), and the audit appears to have been based on examination of the form M208 rather than the CA237 (id, see discussion below). There are implications that some "terminated eligibles"--a separate disallowance category--may have been included (see discussion on p. 7 below).

is of little use here. <sup>3/</sup> At the hearing the State and the Foundation presented evidence and argument solely on the issue of whether HEW's audit findings on the amount of the disallowance were reasonable and based on proper methodology (Transcript, pp. 76-139; State Exhibit 1, Issue 9).

Nowhere in the record does the State contest the determination that the costs involved were unallowable; the dispute concerns the amount, if any, which should be disallowed.

The focus of the dispute over methodology concerns two different audit approaches used by the HEW auditors, which produced substantially different answers to the question of how much should be disallowed for partial month eligibles. The final disallowance was based on the method which produced the higher figure.

The first method involved examination of a form identified as the M208. Undisputed testimony and HEW draft audit findings indicate the following: the M208 was a form prepared by county officials and sent to the Foundation every two or three days, specifically identifying individuals who were determined to be eligible to participate in the Foundation's program. Transcript, pp. 79, 92, 103, 123. These numerous forms were summarized on worksheets, prepared by Foundation staff, which were used as part of the process of billing the State. *Id.*, pp. 91, 123-124. There were 773 of the worksheets for the audit period, and HEW auditors selected 25 of these for review, which covered 1691 persons. *Id.*, pp. 79-80. The auditors then compared these 1691 names with names on the M208 forms, and found a discrepancy:

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<sup>3/</sup> The 1978 audit covered the period July 1, 1969 to January 1, 1975, and was represented as examining anew items the parties previously had subsumed under the title of "partial month and retroactive eligible recipients," called in this audit "retroactive eligibles" (RR, Tab 35, pp. 3-4). Now, however, "duplicate recipient count" was said not to be covered, although it still had "to be interpolated ...to resolve this item" (*id.*, p. 10). When the 1978 audit report was issued, counsel for the State acknowledged that it was useless for determining what was overpaid or underpaid during the shorter time periods of earlier audits, and stated that State auditors had been asked to interpolate the findings to the shorter periods; later the State said that this could not be done "for technical reasons" (*id.*, p. 5; Tab 36, p. 3). The new audit did not say there were no errors; rather, it concluded that at some point during the five-year period of the audit, the Foundation ceased receiving payments altogether on behalf of partial and retroactive eligibles, which allegedly "more than off set the earlier overpayment" (RR, Tab 36, p. 2; and Tab 36, appended audit report, p. 4 and "summary of adjustments" following p. 8).

there were 82 more persons shown on the worksheets, an error rate of 4.85%. Id. Using statistical extrapolation techniques, this error rate was translated into a potential disallowance of between \$13,072 and \$18,985 at the 90% confidence level (mid-point: \$16,029). Id., pp. 80-81; State Exhibit 1, Issue 9; State Exhibits 2 and 3.

The second audit method--used by the HEW auditors to produce the recommended disallowance of \$176,950 in the final audit report--involved examination of a different form, the CA237. Unlike the M208 and the Foundation's worksheets, which contained data on individual eligibility changes, the CA237 was a monthly summary of case load changes prepared by the County primarily as a report to the State. Transcript, pp. 81-82, 92-93. The HEW auditors extracted from the CA237 forms for the audit period the total of partial month eligibles (18,817), and compared this figure to the total reported by the Foundation (40,502); the difference of 21,685 reflected an alleged error rate of about 53.5%, which was translated (based on an average premium rate per eligible of \$8.16) into a recommended adjustment of \$176,950. Id., pp. 82-84; RR, Tab 3, pp. 20-21.

Thus, the two methods produced grossly different error rates. The final HEW audit report uses only the second (higher) rate, and does not mention the alternative method or its lower results. RR, Tab 3, pp. 20-21. The latter method is disclosed only in a draft of the HEW audit report (State Exhibit 3). That draft report discussed the method and results of examining the M208 forms (as explained above), and stated that "for comparison" the auditors also examined the CA237 forms. The draft report goes on to state:

...the count was overstated by up to 21,685 count and the Foundation has been overpaid. The overpayment could total as much as \$176,950...we recommend that [the State] develop procedures for the Foundation to accurately determine the increases in count from the Forms M-208 and that [the State] and the Foundation redetermine the total number of increases for partial month and retroactive approvals. Benefit dues should be adjusted on the basis of the redetermined count and the Federal share returned accordingly. State Exhibit 3, pp. 3-4 (emphasis added).

The draft audit report did not make a specific disallowance recommendation; rather, it recommended that the State "make further determinations and return Federal funds as appropriate" and improve procedures to increase accuracy in recipient count from the M208 forms. Id., p. 5.

The draft audit report is the chief underpinning of the State's claim. <sup>4/</sup> The State argued that "the HEW auditor never attempted to reconcile the apparent different error rate conditions of 4.85% and 53.5%" and that the preliminary draft audit report "seriously undermined the auditor's conclusions...the final HEW audit report was unfairly manipulated so that the weaknesses inherent in the Audit Agency's position would not be evident to the reader." State Exhibit 1, Exhibit 9, pp. 3-4. The State presented as a witness a certified public accountant who testified that the difference in the error rates was significant, and reasonably should have led the auditors to do additional work to determine which rate is more nearly correct. Transcript, pp. 78, 94, 131-133.

The Agency's argument, as presented at the hearing by one of the original auditors, was that the examination of M208 forms was merely a "probe" sample to see if there was a problem; when the probe indicated there was, the auditors used the CA237 forms to arrive at the amount of the disallowance. Id., pp. 97-99, 104-111. The auditor felt the M208 was not entirely reliable, the CA237 was, and, in any event, examining the M208 forms was a much more tedious and time-consuming process than reviewing the CA237 forms. Id., pp. 98-99, 100-105, 121-122. But no attempt was made to verify the CA237 data in relation to the underlying M208 forms or other county records. Id., p. 121.

In our view, the Agency had and has a valid concern about the amount which the State should receive; the record clearly shows that State and HEW audits indicated an overpayment during the period in question. The record also shows, however, that the Agency set its disallowance at the highest possible level in the face of evidence that reasonably counseled further inquiry. The difference in error rates disclosed by the two audit methods is very great. While the Agency witness attempted to show that the M208 examination was merely a probe, nothing else in the record supports that view, and the record as easily may be read to suggest that the choice of the highest possible figure was arbitrary. We conclude that while a disallowance of some amount for partial month eligibles is appropriate, the disallowance cannot be upheld as it now stands.

At the same time, we believe the Agency should have an opportunity to complete the inquiry because even the State's audits--which incidentally

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<sup>4/</sup> The State also argued that the analysis of the M208 forms underlying the first HEW audit method was defective because the sample was insufficiently random. The State argued that the HEW auditor should have selected line items randomly from all of the worksheets rather than using all line items from randomly selected worksheets. State Exhibit 1, Issue 9. The Agency's witness acknowledged that the sample of M208 forms was defective. Transcript, pp. 97, 110.

were based on a review of M208 forms (see Tab 21, p. 2)--suggest overpayments. The State has a reasonable obligation to facilitate the Agency's further inquiry by assisting in locating relevant data and culling it from other records, and Agency auditors should be provided the opportunity to re-examine the data (in particular, the forms M208 for the audit period) so that they may, by means of full review or a valid sampling technique, modify or reaffirm the disallowance. If the State disagrees with the Agency determination after that review, the State may seek the Board's review (and, given the delays which have already occurred in this matter, the Board will provide priority expedited review).

#### Duplicate Capitation Payments

The HEW audit report found as follows:

The Foundation's procedures were not adequate to assure that the recipient count reported to [the State] did not include duplicates. The recipient count reported to [the State] during the period August 1, 1970 through March 31, 1972 included 3,484 duplicate count for San Joaquin [County] and 382 duplicate count for Amador [County]. As a result the Foundation was overpaid \$33,099 (Federal share \$16,540). These overpayments occurred because neither [the State] nor the Foundation specified the method to be used in developing the number of recipient count and, as explained below, the procedures adopted by the counties were inadequate. RR, Tab 3, p. 18. 5/

The report goes on to explain that San Joaquin County duplicated its count for the last three work-days of each month essentially because of an overlapping count for additional eligibles on different reporting forms, and Amador County because it also erroneously reported additional eligibles on two different reporting forms. Id., pp. 18-19.

The State's first audit did not distinguish between duplicated recipient counts, and partial month and retroactive eligibles (RR, Tab 35, p. 10). After the second audit, the State argued that the \$33,099 adjustment was improper because HEW auditors extrapolated from figures for only a few

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5/ Note that the FFP computation here apparently reflects an error, since 50% of \$33,099 would be \$16,549 or \$16,550 depending on how one rounds. This error also is reflected in the total amount reported as the FFP disallowance by the auditors, which we have increased by \$9. The error is also in the stipulated summary prepared by the State. See State Exhibit 1, Introduction, p. 4.

weeks as samples of the audit period, and the samples were not representative (RR, Tab 36, p. 5). The State argued that State auditors "...estimate that only \$10,000 to \$12,000 in duplicate payments were made," although the State added, "In candor, we must state that we cannot back these estimates up with the hard data we would like." Id. The Agency responded that the recommended adjustment was based on a 100 percent review for each month, and not a sample. Agency Response, pp. 8-9.

At the hearing the State stated its position differently: while the HEW auditors did perform a "...100% review to accumulate all recipients reported on the last 3 work-days of each month for the entire contract period," the auditors double-checked their work only by selecting a sample of 50 cases from a "Daily Approval List," a process which the State ambiguously claimed it was "unable to validate." State Exhibit 1, Issue 1.

The Agency's witness, one of the auditors who performed the HEW audit, testified that they had, indeed, done a 100% review of records to arrive at the 3484 duplicate count figure; subsequently they took a sample of 50 names from the daily approval list and certain "batch vouchers" within three days prior to the end of the month, and found "that in every one of the 50 cases," there were duplications. Transcript, p. 214. The testimony was that the latter sample was not the basis for the disallowance, but was merely a check. Id., p. 215. The State provided no evidence or argument to the contrary. Id., pp. 216, 220.

We uphold this disallowance. The record supports its reasonableness, and the State has provided no substantial evidence or argument in support of its position that the duplicate payments were less than those established by the HEW audit.

#### Terminated Eligibles

The HEW auditors determined that the Foundation was overpaid \$128,740 (Federal share \$64,370) in benefit dues for recipients whose eligibility had terminated. RR, Tab 3, pp. 13-14. At the first of the month counties reported the number of eligible recipients to the Foundation on census forms, which were adjusted during the month on M208 forms for, among others, those who moved away or whose benefits were retroactively discontinued. For the period August 1, 1970 through March 31, 1972, the auditors determined that 15,513 eligible recipients became ineligible in this manner, but were not deducted by the Foundation from the number of eligible persons for whom the Foundation billed the State.

There are implications that some terminated eligibles may have been subsumed under the State's findings concerning "partial month eligibles," and the State's audits did not separately address a category of questioned costs dealing with terminated eligibles. RR, Tabs 5, 7; Tab

35, pp. 3, 5, 9; Tab 36, p. 2. The State has not contested the amount of the disallowance; rather, the State argues that it is unreasonable to recover payments for retroactively terminated eligibles at all. Tab 36, p. 6; State Exhibit 1, Issue 2, p. 3.

The State argues essentially that the reduction in terminated eligibles was effectively represented in the capitation rate negotiated between the State and the Foundation, based on which the Foundation was paid by the State, since the rate was the quotient of dividing relevant medical cost data by the recipient count reported by the counties. State Exhibit 1, Issue 2, p. 1. According to the State, "...if the count was overstated (due to a lack of knowledge of retroactively terminated eligibles) during the contract negotiation stages, the premium rates would, by definition, be lower than they otherwise should have been (had the effect of retroactively terminated eligibles been considered)." Id.

The difficulty with this argument is that it means only that a lower capitation rate obviously results from including ineligible persons in the number used as a divisor of the medical cost data; it begs the question whether the Agency should share in the costs related to those ineligible.

The State argues that the HEW auditors used "parochial hindsight" in ignoring the method of computing the capitation rate, since "if the Audit Agency's proposed changes to the eligibility count had been known during the negotiation phases of the contract, the premium rates would undoubtedly have been negotiated at a higher level...." Id., p. 2. The State also claims that the HEW auditors had knowledge that the alleged overstatement of recipient count at the time of contract negotiations did indeed result in lower premium rates. Id.

At the hearing, although the State tried to show through testimony that the logic of the rate-setting process made the later disallowance anomalous, the testimony appeared to indicate that the process actually was one of negotiation tantamount to bargaining, so that rates could not be said to be ineluctible extrapolations from known numbers; certainly, there was no evidence that the negotiators specifically focused on how to accommodate terminated eligibles. Transcript, pp. 153-155; 168-169, 186-188, 198, 200. Further, there is no substantial evidence that the State did, in fact, specifically include terminated eligibles in the capitation rate computation. What the HEW auditors did or did not know was never made clear, and the Agency argued persuasively that that was essentially irrelevant. Id., pp. 191, 195-199.

A main point argued by one of the State's witnesses, Director of Finance of the Foundation, was that persons would continue to receive services through the month even though terminated since they still carried an eligibility card (Transcript, p. 150). If someone was eligible for a part of a month,



the Foundation got a premium for the full month; the "system" did not inform the Foundation that there was an ineligible until after the fact. Id., pp. 150-151. That being so, argued the State, it was never contemplated that there would be an attempt to adjust after termination. Id., p. 152. As part of this presentation, the State's witness disclosed that the Foundation would always pick up additions from the form M208, but not deletions because, according to the witness, the Foundation needed to get funding for the new eligibles, whereas the terminated eligibles still allegedly were receiving services during some post-termination period (id., pp. 157-159, 161-163). But the HEW auditor then offered contradictory testimony, which on balance we find to be more specific and informed, and thus more persuasive, that cards were not released to persons determined to be ineligible by the counties. Id., pp. 173, 177-179. Terminated eligibles, according to this testimony, generally were not involved in a partial month eligibility situation, since as a practical matter they kept their eligibility cards, received services, and were not disclosed on the M208 forms to the Foundation as ineligible until they had had their cards taken away. Id.; see also, HCFA Exhibit 7, which rather more ambiguously makes a similar point in a letter from a State official to the Foundation. The auditor also testified that the disallowance was calculated only for terminations where the county held the eligibility cards. Transcript, p. 190.

Thus, the Foundation did note additions, but not deletions, and their argument for the different treatment is not persuasive in view of the weight of testimony. The State has not presented any evidence specifically supporting the argument that the capitation rate was built on inclusion of payment for these ineligibles; in any event, that argument would go to the question of mutual rights and liabilities under the contract between the Foundation and the State, not directly to the question of what costs the Agency should share. The State has not offered, and we are not aware of, any legal basis for a conclusion that the Agency should share in costs attributable to ineligibles. Therefore, we uphold this portion of the disallowance.

#### "Prior Authorization" Costs

The HEW audit resulted in a disallowance of \$167,924 (Federal share \$83,962) representing State reimbursement to the Foundation for costs of "prior authorization" of certain services provided by the Foundation. RR, Tab 3, p. 40. The auditors determined that this was not provided for in the contract between the State and the Foundation, and was a function which could not be delegated under State procedures. Id., pp. 40-41.

Shortly after the HEW auditors had completed their field work, but before the audit report was issued, the State amended the contract. The contract amendment provided approval for the costs in question. Transcript, p. 9; State Exhibit 1, Issue 4; RR, Tab 25. The State argued that the amendment was a "written ratification of a prior existing oral agreement, so it was not in essence a retroactive amendment." Transcript, p. 9.

The Agency's position essentially was that payment here would be unreasonable because there was inadequate evidence of the oral agreement, prior authorization was inappropriately exercised by a provider under State law, and, generally, that the use of a retroactive amendment (which had problems passing muster within the State) "smells." Transcript, p. 39.

We reverse this disallowance in the amount of \$161,134 and uphold it in the amount of \$6119; the balance of \$671 is not in dispute. 6/

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6/ The disallowance amount was \$167,924, which included the sum of \$16,138 which HEW determined was not allowable on other grounds. RR, Tab 3, p. 40; Transcript, pp. 64-65. The latter sum was made up of \$14,974 in consultant's fees, \$671 in interest, and \$493 for actuarial expenses. Id. The interest is not in issue here (see State Exhibit 1, Introduction, p. 4 and Issue 7; Transcript, p. 65). The State presented only a brief conclusory statement (State Exhibit 1, Issue 7) and no evidence concerning reasonableness of the actuarial expenses. Moreover, the State had originally not disputed the auditor's finding that the contract did not cover actuarial expense (Application for Review, Exhibit II, p. 4). Accordingly, we uphold the disallowance of this amount. This leaves the consultant's fees (\$14,974), and some apparent confusion concerning what was at issue in relation to those fees. The audit report indicated that \$9348 of the \$14,974 was disallowed because it represented an excess over allowable rates (Tab 3, p. 43), as discussed herein. \$4771 was disallowed because it was not supported by adequate documentation, and \$855 was misclassified (id., pp. 43-45).  $\$4771 + \$855 = \$5626 + \$9348 = \$14,974$ .

At the hearing, the parties focused only on the excess rate portion, and did not mention the problems of alleged lack of documentation and misclassification of costs; in fact, the parties appear to have erred by, first, misstating the \$14,974 figure as a slightly lower and illogical figure (Transcript, p. 65) and second, by assuming that the latter incorrect amount was all related to the excess rate issue. Id., pp. 65-66. The audit report makes it clear that only \$9348 relates to the excess rate issue, and the parties did not clearly address the balance of \$5626. The earlier record does not elsewhere contain any State arguments specifically addressed to this amount. We note that all but \$855 of the amount is related to adequacy of documentation, and we urge the parties to try and resolve this matter by agreeing on submission and review of further information or affidavits, as they have done with another issue in this case. We must uphold the disallowance of the \$5626 because we have no basis upon which to do otherwise; but given the confusion in the record, we will afford the State the opportunity to present argument on this particular matter (i.e., the \$5626 portion of the disallowance) within 60 days after receipt of this decision, if unable to reach an agreement with the Agency.  $\$5626 + \$493 = \$6119$ , the amount of this disallowance upheld (subject to further review of the \$5626 portion).

The Agency did not dispute that the payments in question were made during the period of the audited contract, nor that the services for which the costs were incurred were rendered, nor that the services were appropriate, nor that the State bore its 50% share of the costs. Transcript, pp. 41, 43-45. The Agency did not argue that there was any specifically applicable rule that would prohibit payment in the circumstances here nor, in spite of an invitation, did the Agency argue that Agency approval was required. Id., p. 10; State Exhibit 1, Issue 4. Further, Agency counsel said the Agency would "stipulate to the fact that the State did duly approve" the contract amendment. Id., p. 43; see also p. 44.

The Agency did try to show that there was no oral agreement to bridge the gap between the audited contract and the contract amendment, but that merely begged the unanswered question whether one was required; in any event, the Agency did not present evidence adequate to rebut the State's evidence that there was an oral understanding. See Transcript, pp. 9, 23, 44-45; amended contract in State Exhibit 4, Issue 6 (stating that "both parties have entered into a verbal agreement effective July 31, 1970"). The Agency's evidence (other than its bare assertions) consisted of Exhibits 2, 3, 4, 5 and 6 (5 was withdrawn during the hearing after its relevancy was questioned; Transcript, p. 62). Exhibits 4 and 6 are both letters between State officials discussing how to overcome the recalcitrance of the State's Department of General Services (DGS) for approval of contracts (as to the DGS position, see HCFA Exhibits 2 and 3). As the State argued (Transcript, pp. 47, 51, 60), it is not clear whether these letters refer to the specific transaction in question here (even the Agency witness admitted confusion about dates, amendments, and the relevance of these letters; id., pp. 52-57). Even if the letters were clearly relevant, they at best provide only ambiguously suggestive language that State officials were, as the Agency appears to imply, colluding to contrive a spurious after-the-fact agreement. The letters merely appear to be a record of bureaucrats exchanging views on how best to present their argument to other bureaucrats in order to overcome technical hurdles. In any event, the DGS eventually approved the arrangement, and it is useful to remember that the State provided half the funds, which helps rebut the highly speculative proposition that the State was acting in bad faith. Transcript, pp. 39, 42-44.

The Agency also argued that the disallowance was justified based on certain State regulations which prohibited delegation of the prior authorization function. Transcript, pp. 45, 63. However, the contract, as amended, gave the Foundation prior approval authority, with the State rather ambiguously reserving the "right to be the final authority" on matters pertaining to prior authorization. State Exhibit 1, Issue 4; see also, Transcript, p. 70. As previously stated, we do not find the contract amendment invalid, and, as Agency counsel pointed out, if the amendment stands, this collateral issue disappears. Transcript, p. 44. State counsel took the position that State administrative practice was

not violated by this arrangement (*id.*, p. 70). The Board is not in a position to second guess the State on interpretations of its own administrative restrictions in circumstances like those here.

The final matter to be considered concerning "prior authorization" costs concerns the \$9348 portion which allegedly represented an excess over allowable rates for consultant fees (see discussion under footnote 6), providing a separate basis for this portion of the disallowance. The State Administrative Manual (SAM) set a rate of \$15 per hour for the professional services involved in this disallowance, and the HEW auditors found that some services had been charged at a slightly higher rate; the auditors questioned the excess over the \$15 rate (RR, Tab 3, pp. 43-44). It is important to note that the Agency witness, one of the original HEW auditors, did not find the rates charged unreasonable; rather, the disallowance was taken solely because the rates exceeded the amounts mentioned in the SAM. Transcript, pp. 72-74. The State's position was that the SAM was merely a non-binding guideline, and that the State sometimes simply had to pay what the market required; the Agency did not dispute this. Transcript, pp. 71, 73-74. The Agency's Exhibit 2 contains an indication that the SAM policy could be waived (p. 2). The amended contract provided for payment of fees for consulting doctors at a higher rate. (State Exhibit 1, Issue 4). Based on these considerations, we are not persuaded that the record supports the disallowance.

#### Overstatement of "Medically Needy Only" (MNO) Recipients

The Agency disallowed \$75,676 (\$37,838 FFP) <sup>7/</sup> for alleged overpayments by the State for a certain category of recipients (MNOs) who were ineligible. The overpayment allegedly resulted from a reporting process failure attributed to Foundation procedures. RR, Tab 3, p. 15. The State did not contest the substantive eligibility issue; rather, the dispute concerns the amount of the disallowance and how it was determined.

The HEW audit report indicates the disallowance was computed as follows:

First, the auditors determined that there was an overstatement of 213 recipients, so that the State overpaid the Foundation \$1,333 (\$667 FFP). The State has not disputed this (see Transcript, p. 247), and we uphold this portion of this disallowance without further analysis.

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<sup>7/</sup> Unlike other elements in dispute, the parties frequently addressed this one in terms of the amount of FFP rather than the overall disallowance amounts.

Second, using the Form MC-177 (Record of Health Care Costs) for 49 randomly selected MNO recipients, the auditors determined that 46, or 94%, were ineligible, and estimated therefore with a probability of 90% accuracy that FFP paid for the ineligibles was between \$29,457 and 44,886 (with the "most likely," or mid-point figure, being \$37,171). RR, Tab 3, p. 16.  $\$37,171 + \$667 = \$37,838$ , the amount of FFP disallowed.

At an earlier point in the dispute, the State argued essentially that its own audits had found different results, which had to be interpolated, and that the Agency in any event should credit the Foundation for adjustments to eligibility count and resulting billings made outside the audit period. RR, Tab 35, p. 6; Tab 36, p. 4. At the hearing, the State indicated that its "original response relative to this issue may in retrospect be in error" (State Exhibit 1, Issue 3) and proceeded to attack the HEW audit methodology. The State argued that the sampling may have been biased and that even assuming that the sample was valid, the estimated nature of the proposed adjustment reasonably calls for use of the lower range limit of the disallowance rather than the mid-point of the range, which would result in an adjustment downwards in the FFP disallowance of \$8,381. Id.; and Transcript, pp. 227, 261.

The speculation about bias arises from the fact that the percentages of the sample items used, in relation to the time periods from which drawn, appeared quite different for three time periods: 26% fell in the period 8/70 - 12/70, 8% fell in the period 1/71 - 6/71, and 66% fell in the period 7/71 - 3/72. State Exhibit 1, Issue 3. 8/ But there are several reasons why these figures alone are not sufficient to persuade us the sample was unbalanced. First, the 66% sample was for an eight-month period, whereas the two other periods were of only four and five months. Second, the sample size--49--was numerically small, so that expressing its breakdown by period and percentage tends to distort perception of the magnitude of the differential. Third, the State's witness affirmed that while the sample size was small, it was statistically sufficient in this case (Transcript, p. 258). Fourth, the audit report describes a similar sample of the same kind of records for a different time period (not in issue in this appeal) which produced an error rate only slightly higher, indicating some consistency in the sampling results (RR, Tab 3, p. 17; Transcript, pp. 254-258):

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8/ These figures were drawn by a State witness from HEW audit workpapers, according to testimony. Transcript, p. 223. The Agency witness, the HEW auditor who prepared the figures, had left the hearing by the time this issue arose. We take the figures at face value because the Agency has not disputed their validity.

Having determined that there is no persuasive evidence of bias in the sample, we also conclude that the Agency did not unreasonably set the recovery amount at a mid-point. The State's witness repeatedly testified that the question of where to set the amount was a "judgment call" (Transcript, pp. 226-227, 258, 260). The witness stated he likely would have chosen the lower limit because it would mean the error is at least that amount, but he acknowledged that to do so would also mean that the actual error rate would very likely be considerably higher (Id., pp. 226-227, 231, 234). The State's main point was that given the possibility of bias in the sample, the auditor should have been more conservative (Id., p. 227), but since we do not find that there was such bias, this point becomes less persuasive. Choosing the mid-point, as the State's witness acknowledged, means that the auditor chose the most probable error point. Id., p. 233. An Agency witness testified that general Agency policy was to choose the most reasonable estimation of where the error occurred (Id., p. 243), and that while reasonableness dictates that one be more conservative if sampling is less reliable, that did not appear to be appropriate here (Id., pp. 246-247). We uphold the disallowance.

#### Other Issues

A portion of the disallowance concerned \$56,627 related to a contract with the University of California (State Exhibit 1, Issue 5). Of this amount, the State conceded that \$1,193 was unallowable (id., Issue 6). At the hearing, the Agency stipulated to the withdrawal of the remainder (\$55,434) of this disallowance (Transcript, p. 272).

Another portion of the disallowance concerned \$20,793 related to allegedly unexpended funds (State Exhibit 1, Issue 8). At the hearing, the parties agreed to a further exchange of information in support of a tentative resolution (Transcript, pp. 292-294), and subsequent to the hearing, the Board was advised of the parties' agreement. Two other findings of the HEW audit were uncontested, \$1,969 for "unauthorized interest" and \$1,190 for certain payments to consultants. (State Exhibit 1, Introduction, p. 4).

Thus, \$80,579 (\$40,290 FFP) of the original disallowance is no longer in dispute before the Board.

#### Conclusion

Based on the foregoing, the disallowance is upheld in part and reversed in part, as follows:

"Partial month eligibles":

Disallowance of \$176,950 (\$88,475 FFP) reversed, provided that the State facilitates Agency redetermination (see discussion).

Duplicate capitation payments:

Disallowance of \$33,099 (\$16,549 FFP) upheld.

Terminated eligibles:

Disallowance of \$128,740 (\$64,370 FFP) upheld.

"Prior authorization" costs:

Disallowance reversed in the amount of \$161,134 (\$80,567 FFP) and upheld in the amount of \$6,119 (\$3,060 FFP); balance of \$671 (\$335 FFP) not in dispute.

Overstatement of MNO recipients:

Disallowance of \$75,676 (\$37,838 FFP) upheld.

Other issues:

The balance of \$80,579 (\$40,290 FFP) is not now in dispute before the Board.

In summary, we uphold the disallowance in the amount of \$243,634 (\$121,817 FFP), we reverse in the amount of \$338,084 (\$169,042 FFP), and \$81,250 (\$40,625 FFP) is not in issue (Totals: \$662,968 (\$331,484 FFP)).

/s/ Cecilia Sparks Ford

/s/ Alexander G. Teitz

/s/ Norval D. (John) Settle, Panel Chair