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December 17, 2010

Carole Kessel  
Chief Examiner  
North Dakota Department of Insurance  
600 East Boulevard Ave., Dept. 401  
Bismarck, ND 58505-0320

**Re: Noridian Mutual Insurance Company – Report on Targeted Examination**

Dear Ms. Kessel:

On behalf of Invotex Group, I am pleased to submit our report relating to the Targeted Examination of Noridian Mutual Insurance Company. Our report is attached, and we welcome your comments. A Summary of Findings and Recommendations has been provided for your convenience.

I would like to acknowledge your support and that of your staff, as well as the support of Noridian's management and staff. We appreciate this opportunity to have served you and the North Dakota Insurance Department. Tim Foley and I would be pleased to discuss our report and the resulting findings and recommendations with you at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "A. Thomas Finnell, Jr." with a stylized flourish at the end.

A. Thomas Finnell, Jr.  
Managing Director

**Report on:**  
**Targeted Examination of**  
**Noridian Mutual Insurance Company**  
**December 17, 2010**

## Table of Contents

<b>Abbreviations and Acronyms .....</b>	<b>ii</b>
<b>Summary of Findings and Recommendations .....</b>	<b>1</b>
<b>Noridian Background and Assignment.....</b>	<b>8</b>
<b>Noridian’s Cost Allocations – Amounts Reported.....</b>	<b>12</b>
<b>Noridian’s Cost Allocation Policy and Related Governance .....</b>	<b>26</b>
<b>Noridian’s Cost Allocation Methodology and Related Processes.....</b>	<b>28</b>
<b>Allocation of Costs Between Self-Funded v. Fully Insured Business .....</b>	<b>39</b>
<b>Review and Assessment of Internal Audit Work.....</b>	<b>48</b>
<b>Assessment of Noridian’s AFRMR Compliance for Potential Reliance .....</b>	<b>51</b>
<b>Review and Assessment of 2009 External Audit Workpapers – Eide Bailly LLP Statutory Audit.....</b>	<b>53</b>
<b>Review and Assessment of Deloitte Study .....</b>	<b>54</b>
<b>Review and Assessment of DCAA and Other Large Group Audit Reports.....</b>	<b>56</b>
<b>Review and Assessment of Sherlock Expense Evaluation Report.....</b>	<b>59</b>
<b>Invotex’s Assessment .....</b>	<b>62</b>

## Abbreviations and Acronyms

AFRMR	Annual Financial Reporting Model Regulation
ASC	Administrative Services Contract
ASO	Administrative Services Only
BCBSA	BlueCross BlueShield Association
BCBSND	Blue Cross and Blue Shield of North Dakota
CAP	Corrective Action Plan
CAS	Cost Accounting Standards
CMS	Centers for Medicare and Medicaid Services, the U.S. federal agency that administers Medicare, Medicaid and other programs
Corelink	Corelink Administrative Solutions, a subsidiary of NMIC
DCAA	Defense Contract Audit Agency
Deloitte	Deloitte Consulting, LLP
Department	North Dakota Department of Insurance
DHHS	Department of Health & Human Services
DSC	Dental Services Corporation of North Dakota, an NMIC affiliate
EB	Eide Bailly LLP, Noridian's independent audit firm
EIC	Executive Incentive Compensation
FAR	Federal Acquisition Regulations
FEP	Federal Employee Program
GNC	Governance and Nomination Committee of NMIC's Board
InvoTex	InvoTex, Inc., d/b/a InvoTex Group
Legacy Contracts	Medicare Part A administration contracts issued prior to the Medicare Modernization Act of 2003
LML	Lincoln Mutual Life and Casualty Insurance Company, an affiliate of NMIC
LOB	Line of Business
MAC	Medicare Administrator Contracts
NAS	Noridian Administrative Services, LLC, a subsidiary of NMIC
NBPA	Noridian Benefit Plan Administrators
NDPERS	North Dakota Public Employees Retirement System
NISI	Noridian Insurance Services, Inc., a subsidiary of NMIC
NMIC	Noridian Mutual Insurance Company, d/b/a BlueCross BlueShield of North Dakota
Noridian	NMIC and its subsidiaries and affiliates
PAC	A Noridian time coding and tracking database
PAR	Pay-at-Risk, the incentive component of compensation
PPACA	Patient Protection and Affordable Care Act
Sherlock Report	Sherlock Expense Evaluation Report
VSI	North Dakota Vision Services, Inc., an affiliate of NMIC

## Summary of Findings and Recommendations

1. Charges from NMIC to NAS totaled \$115.5 million in 2008, of which \$103.9 million is the pass-through of expenses incurred directly for NAS' benefit but which were initially paid for by NMIC, primarily payroll and related employee benefit charges.

*If Noridian plans to continue to administer NAS' payroll and benefits programs, we recommend the disbursements be made directly out of a NAS bank account. This approach would significantly reduce the amount of expenses borne initially by NMIC, only to be allocated to, and later reimbursed by, NAS. This method would provide more transparency with respect to NMIC's financial support of NAS; to the extent NAS might need future financial support from NMIC, such support would then no longer flow through intercompany allocations in the ordinary course of business, rather it would take some other form, e.g., a surplus note, capital contribution, or other means that would be more explicit and possibly require the Department's approval. See page 15.*

2. Expense allocations to NAS appear to be reasonable. Direct assignment of expenses to NAS is used extensively. The allocation of shared information services expenses and corporate overhead is based on appropriate allocations methodologies that are applied consistently throughout the organization. *See page 17.*
3. The various allocation bases used by Noridian are, for the most part, as recommended by BCBSA as guidelines for its members; such methods were developed in the years following the introduction of Medicare by BCBSA working groups as an informal endeavor and with little formal documentation. The documentation of such methods that is available at NMIC consists of a single binder that has not been updated in over 20 years. Noridian has, in some instances over the years, modified those BCBSA-recommended allocation methods or adopted alternate methods to meet specific needs.

*Noridian should take such steps as are necessary to ensure that key aspects of its cost allocation process are adequately documented and up-to-date. This would include the rationale behind the selection of various allocation bases, a description of the underlying process, and related controls. See page 21.*

4. Claim counts (numbers of claims processed) should be used where the costs of processing the average claim does not vary significantly with the size of a claim. Claim values (the dollar value of claims) would be more appropriate in instances where the value of a claim significantly impacts the resources required for its adjudication. For example, costs related to pre-certification of coverage for medical procedures generally relate to surgical and other more expensive procedures. However, Noridian uses claim counts for the allocation of expenses associated with Medical Necessity Reviews and pre-certification authorizations.

*Noridian should investigate the feasibility of measuring actual case-level statistics to more accurately allocate expenses associated with Medical Necessity Reviews and pre-certification costs to lines of business, weighing the cost of such a change against the value of the improved allocation precision. See page 22.*

5. Noridian's use of contract counts and/or premium may be reasonable allocation bases for many marketing costs; however, the 85%/15% allocation to NMIC and its subsidiaries, respectively, involves documentation that is inadequate and out-of-date, and does not provide support for management's decision to phase-in the impact of changes made to the process.

*Noridian should document its reasoning as to why an average of contract counts and premium is appropriate. It should also document the basis for the 85% NMIC weighting that has been in place since 2004. Given that the 2004 study referenced by management involves some level of subjectivity, this study should be updated on a regular basis to ensure key assumptions remain valid. Additionally, in the future, Noridian should not phase-in corrections to allocation processes; rather, they should be implemented immediately. See page 24.*

6. NMIC's executives have in the past used some "top-level adjustments" to alter cost allocation results. While many companies occasionally use top-level adjustments as an element of financial reporting, those adjustments should be subject to strong internal controls because of the small number of very high-level individuals who are involved and the opportunity for conflicts of interest, as well as the by-passing of customary controls.

*Where possible, the use of top-level adjustments in the allocation process should be avoided; if that is not possible, then those top-level adjustments that do occur should be well-documented and with explicit documented approvals of qualified senior executives and with notice to Internal Audit. Upon subsequent investigation, Internal Audit should report their findings not just to NMIC, but also to the boards of other affiliates whose allocations have been impacted by these top-level adjustments. See page 25.*

7. A formal written cost allocation policy does not exist at Noridian, an issue that has been noted by Noridian's Internal Audit department in a January 2010 report.

*Noridian should take such steps as are necessary to assure that there is adequate written and properly approved documentation supporting the cost allocation function. This would include a formal cost allocation policy and supporting business process documentation. The cost allocation policy should be approved by senior management of NMIC and each of its subsidiaries and affiliates that are subject to the cost allocation process. The cost allocation policy should also be subject to review by the Audit Committee of NMIC inasmuch as cost allocation processes have been identified and reported by Noridian's independent auditor to NMIC's Audit Committee as being among the most sensitive estimates affecting NMIC's financial statements. See page 26.*

8. Noridian's cost allocation process documentation does not include the reasoning as to why particular allocation methods were chosen.

*Noridian should update the cost allocation database to document why each allocation method used was deemed to be the most appropriate. See page 29.*

9. For Corporate Project Tracking, MIS and PeopleSoft, there are no controls to ensure time is charged to the correct project code aside from a limited choice of available project codes. Management has the opportunity but not the requirement to review the time coding of the employees they supervise as part of the weekly time reporting approval process.

*Noridian should institute controls over the input of time to the MIS Project Tracking System to assure that time is charged to correct project codes. While managers are required to approve employee time sheets on a weekly basis, other controls could include project cost budgeting, reporting and variance analysis. See page 32.*

10. Noridian's statistical allocations are more manual in nature and are generally based on objective statistics of usage or causal measures deemed appropriate by management. Examples of such bases include the use of claim counts, premium dollars, salary dollars and system usage. The form and nature of these calculations vary considerably. However, a common characteristic is the manual or spreadsheet-based nature of the calculations. Additionally, these allocations require the manual keying of data from the spreadsheets into other databases that ultimately feed the ledger (Manpower by way of BOLTS, for Burroughs Online Transaction System).

*Noridian should develop a plan that would enhance the system capabilities and support of its cost allocation process; reduce significantly the amount of manual rekeying of data; reduce the usage of spreadsheets; promote the electronic collection and interface of data from underlying systems and sources; and improve related internal controls. See page 33.*

11. While the new Patient Protection & Affordable Care Act ("PPACA") requirements might be viewed as an extension of the requirements for the reporting of expenses within the Underwriting & Investment Exhibit Part 3, the importance and visibility of this information will be increased significantly, as certain operating expenses will impact the medical loss ratios as determined pursuant to the new PPACA and will ultimately impact potential member premium rebates. The existing separation of this process from the core cost allocation system will likely be deemed inadequate.

*Noridian should closely follow the development of new reporting requirements relative to MLR reporting. New expense studies may need to be performed, with the resulting allocation factors under additional scrutiny. Both system and reporting capabilities in this area will likely have to be expanded, an objective which may be more complex for Noridian to achieve due to its lack of adequate documentation, extent of one-off spreadsheet applications, key-man dependencies and legacy systems involved in its allocation processes. See page 34.*

12. Invotex found that the documentation made available was insufficient to provide an adequate understanding of the environment, processes and controls in place at Noridian related to cost allocations. In numerous instances, Noridian's staff appeared to use reasonable calculations and procedures relating to cost allocations and documenting those results, but the work relied on their own institutional knowledge about past practices at the company inasmuch as there

were no written policies and procedures that they could follow. Absent having such information in a documented form that has been approved by management, it is not possible to independently verify that the actual procedures are being performed as intended or are authorized. Because Noridian currently lacks a formal, overarching Cost Accounting Policy, it also is more difficult to assure that cost accounting practices used across the enterprise uniformly adhere to corporate intent.

*Cost allocation process documentation should be prepared, approved by management, maintained and used in practice to support the performance of cost allocation-related procedures. Such documentation should be identifiable to a process owner whose responsibility is to prepare and maintain the documentation with objectives, procedures and responsibilities clearly identified; reviewed and approved by appropriate levels of management; available for testing against actual practices by internal and external auditors; and made available upon request by third-party auditors, e.g., DCAA, DHHS, Centers for Medicare and Medicaid Services (“CMS”), the Department, and other auditors representing large groups. See page 37.*

13. Noridian’s cost allocation methodology for the identification and reporting of self-funded expenses for years 2008 and 2009 was not consistent with the entity-level allocation process. Codes were not established to capture and distinguish costs between self-funded and fully insured business. This required estimating the corresponding amounts through a series of spreadsheet applications that were performed outside of the normal allocation system and methodology and which therefore may not have been subjected to the same degree of internal control. Furthermore, Noridian’s cost allocation methodology for stop-loss business continues in 2010 to be inconsistent with the entity-level process because expenses are not coded to that line of business, but rather are estimated within this same spreadsheet.

*Noridian’s identification and allocation of self-funded plan expenses should follow a consistent methodology, employing the same processes and subject to the same controls utilized in the entity-level cost allocation system. Stop-loss business should also be segregated within the financial reporting and cost allocation systems to eliminate the need for high-level, manual adjustments to estimate the allocation of expenses. See page 43.*

14. With respect to marketing expenses for self-funded plans, their relatively larger size lowers per unit costs, but the complexity of such plans tends to increase the amount of time and expense generated during the marketing effort. Noridian’s management has asserted that, in general, expenses allocable to fully insured plans would be higher than for self-funded plans; that NMIC has no available means to measure an appropriate magnitude of the unit cost differential between such plans; and that marketing expenses for self-funded plans would be lower on a per-unit basis due to the size of such plans however the complexity of such plans tends to increase the amount of time and expense generated during the marketing effort. The end product of the allocation methodology “is what it is” with no means to independently verify that the end result of the allocation process is reasonable.

*Invotex recommends that NMIC should enhance its financial reporting and cost allocation methodology and systems to capture the necessary information to report on the profitability of self-funded and fully insured plans at various group size levels. Stop-loss business should*

*also be segregated within the financial reporting and cost allocation systems to eliminate the need for high-level manual adjustments to estimate the allocation of expenses. Management should perform an updated and comprehensive study of marketing expenses that considers the additional effort required to administer and sell self-funded policies and the size of group policies written and inforce. See page 47.*

15. While the determination of allocation method reasonableness was a stated objective for the 2009 Internal Audit, the resulting work papers and report make no mention as to whether such a determination was made or not. Internal Audit represented to Invotex that, in the absence of a definitive statement in the report, that Invotex should interpret the audit result as having found no evidence of deficiencies in the allocation methodologies. Given the complexity of the cost allocation system, that much of the underlying documentation appears to be inadequate, the materiality of the amounts involved as well as identified internal control weaknesses, it is apparent that Internal Audit could do more in this area.

*The determination of allocation method reasonableness was a stated objective for the 2009 Internal Audit, and the subsequent report stated no exceptions in that regard. Nonetheless, Internal Audit's work papers do not explicitly document the process or rationale used to evaluate reasonableness of the allocation methods used. Given the complexity of the cost allocation system, that much of the underlying documentation appears to be inadequate, the materiality of the amounts involved as well as identified internal control weaknesses, it is apparent that Internal Audit could do more in this area. See page 49.*

16. Noridian's efforts to comply with the AFRMR is not sufficiently advanced to result in information, process documentation, or testing of internal controls that would provide additional insights relative to Noridian's cost allocations. A full evaluation of Noridian's plans and efforts to implement and comply with the AFRMR's provisions is outside the scope of the Invotex examination. Nonetheless, cost allocations are an area of concern to the Department, and Noridian's independent auditors have identified expense allocation agreements as a key risk area. Therefore, it would appear prudent for Noridian to assure that cost allocations are covered by their AFRMR compliance efforts and in time to be able to file on a timely basis Management's Report on Internal Control over Financial Reporting as of December 31, 2010.

*Noridian should continue its efforts to resolve resource issues with the Internal Audit department and to take such other measures as are appropriate so as to assure timely compliance with the AFRMR. Although not required by the AFRMR itself, the Department's specific interest in Noridian's cost allocations would appear to warrant that the resulting process descriptions and testing results relative to cost allocations nonetheless be provided to the Department for its review. See page 52.*

17. Invotex did not identify comments or findings in the DHHS or DCAA audit reports that would indicate fundamental flaws in NMIC's cost accounting methodology. The exceptions noted in the reports focus on individual items and appear to be primarily the result of inadequate documentation. The findings in these reports appear to be focused on compliance, but do not suggest that there are significant issues relative to Noridian's cost allocations that would be material from a financial perspective. See page 58.

18. Based on Invotex’s review of the Sherlock Report, there are no matters presented therein that would provide insights as to the reasonableness of Noridian’s cost allocation processes or results.

*As instructed by the researchers who authored the Sherlock Report, NMIC excluded from the reported expenses certain systems enhancement costs deemed to be one-time expenditures and not reflective of routine operating expense levels. With the exception of these system enhancement costs, the membership, premium and expense data used in the Sherlock Report appear to be consistent with NMIC’s Annual Statement. Had these expenses been included in the study, the 2008 per-member-per-month administrative expense rate as shown in the Sherlock Report would have increased from \$16.28 to \$16.54, which would not significantly impact one’s interpretation of the results. See page 61.*

19. Noridian’s cost allocation process involves many automated programs and systems, including the following:

- BOLTS - the interface system “Burroughs Online Tracking System”
- WorkForce - the time recording system
- MIS - an alternate time recording system for recording time for IT Projects and storing IT Projects
- PTS - Project Tracking System - holds all projects against which time can be recorded.
- Smartstream - brings together the percentages and does the allocation
- ManPower - calculates allocation percentages for Labor Costs
- PAC – an internally developed time coding and tracking system

The controls over the tables utilized in Noridian’s automated allocation-related systems do not include adequate change controls and testing around the process. Additionally, some of the programs are not well documented as they are very old and have not been changed for many years.

*It is recommended that change controls be implemented and appropriate testing performed to avoid incorrect modifications to the tables that could lead to erroneous allocations. Documentation should be developed that would allow analysis of the functionality and improvements and modifications made as needed. See Page 38.*

20. Within the “Form 33” allocation process there exists the potential for the entry and use of incomplete data, as the entry screen has some numbers that could be skipped and left as they were the previous month, or left blank. Checks are in place, but they are not adequate to ensure such errors would be caught. The “Semi-Automatic” process includes use of a similar entry screen to Form 33 and therefore could be incomplete and the error not be detected.

*It is recommended that a formal data entry control be put in place whereby the data that is entered is highlighted or the data from the previous month is deleted to allow the determination that all required current entries have been made and that all non-current data is not carried forward unintentionally. See Page 38.*

21. For labor allocations, some labor codes are loaded from PAC into ManPower. One control is a check for an invalid code number. However, there is no control in place to detect the use of an incorrect, yet valid, code number. Additionally, the capability to designate a task code as “inactive” deletes the history of that particular task. Users of the system have been instructed to avoid using this system capability, yet there is no control to ensure this does not occur.

*All labor codes should be validated as both valid and correct. The manual control to avoid the designation of a task to “inactive” status introduces the potential for important audit trails and data to be deleted. A control should be in place to prevent low the use of this function or to correct its functionality. See Page 38.*

22. Noridian’s Travel and Entertainment Policy appears to adequately address most procedures for handling of travel expenses. We do note, however, that travelers are not required to report the names and titles of other Company personnel traveling together. Receipts are required for expenditures of \$50 or more. The policy appears to adequately address IRS requirements for documentation. General travel requirements appear adequate with guidance on obtaining the lowest available price with reasonable conditions. Restrictions on the use of business class air travel appear to be reasonable, e.g., with authorization business class travel would be permissible on longer flights. Guidance is provided on per diem rates and restricts reimbursement to such rates. The policy provides reasonable guidance for most situations in which company employees would be required to travel on company business. The policy does not specifically address out-of-state meetings or the use of charter aircraft.

*Invotex recommends more stringent rules for the requirement of receipts for out of pocket expenditures, and we recommend that travelers report the names and titles of other Company personnel traveling together (to facilitate travel expense audits). The policy should also be revised to address out-of-state meetings and the use of charter aircraft. See Page 27.*

23. Based on the work performed, Invotex found that the overall approach used by Noridian to address cost allocations and the underlying processes, practices, and allocation bases to be reasonable in light of industry practices. Such is likely the result of years of trial and error combined with years of experience in addressing audits performed by DCCA, DHHS, and other larger groups, as well as benefiting from the collective experience of BCBSA.

That said, Invotex did find ample instances of inadequate documentation, at all levels, from the top-level understanding of the process to the more detailed supporting documentation of calculations. There are instances where management cannot provide an explanation as to why a particular allocation method is being used, noting simply that it has been used for some time. Control weaknesses exist in the form of key-man dependencies, use of out-of-date legacy systems, extensive need for manual re-keying of data, and more.

Noridian’s efforts to address these matters show some promise, but are yet incomplete. The CAP relating to Internal Audits 2009 report on cost allocations is not yet closed, and the efforts to comply with the AFRMR and extend its benefits to the cost allocation function are still in process. *See page 62.*

## Noridian Background and Assignment

About Noridian: Noridian Mutual Insurance Company (“NMIC,” d/b/a BlueCross BlueShield of North Dakota) is a member of the Blue Cross and Blue Shield Association (“BCBSA”), an association of independent Blue Cross and Blue Shield plans. NMIC is incorporated as a mutual insurance company under the North Dakota Nonprofit Corporation Act and is subject to regulation by the North Dakota Department of Insurance (the “Department”). NMIC is the parent company of various subsidiaries and also operates within a holding company structure with other affiliates. In this report, “Noridian” refers to the collective organization, i.e., NMIC and its subsidiaries and affiliates.

Noridian markets and provides insurance in North Dakota and in certain other states consistent with its licensing and as authorized by the laws of each respective state. NMIC provides individual, group and association health insurance and pharmaceutical benefits under traditional and preferred provider organization contracts. NMIC contracts with hospitals, physicians and other providers of health care in order to obtain discounts for subscriber members.

Noridian also performs administrative services such as billing, collection and claim processing for other Blue Cross and Blue Shield plans, various governmental agencies and various fully and modified self-funded groups within the State of North Dakota. Noridian’s administrative services business represents a significant portion of its business.

The Current Targeted Examination by Invotex: Invotex, Inc. (“Invotex,” d/b/a Invotex Group) was engaged to assist the Department with an expansion of its prior Target Financial Examination of Noridian which was performed relating to the five-year period from January 1, 2004 through March 31, 2009. Specifically, Invotex was engaged to examine and report on the cost accounting and allocation methodologies used by Noridian to allocate incurred expenses amongst NMIC and its subsidiaries and affiliates, as well as to provide an update on certain matters that were included in the prior Target Financial Examination report.

To gain an adequate understanding of the cost allocation environment at Noridian, Invotex developed a multi-faceted approach that is described in subsequent sections of this report, as follows:

- Noridian’s Cost Allocations – Amounts Reported. This describes amounts that have been allocated to the various functions and entities as a result of Noridian’s cost allocation process. *See pages 12-25.* This section provides information about the materiality of those allocations as well as about the related intercompany cash flows.
- Noridian’s Cost Allocation Policy and Related Governance. *See pages 26-27.*
- Noridian’s Cost Allocation Methodology and Related Processes, i.e., the process by which Noridian determines and records amounts to be allocated. *See pages 28-38.*
- Allocations of Costs Between Self-Funded v. Fully Insured Business. *See pages 39-47.*
- Invotex’s Assessment regarding the foregoing matters. *See the Summary of Findings and Recommendations at page 62 of this report.*

Invotex's procedures included the following:

- Inquiry of management and staff of Noridian including those in Finance whose responsibilities include performing and recording cost allocations, as well as those in Internal Audit whose responsibilities include assessing the company's compliance with policies and procedures with respect to cost allocations.
- Participation in interviews of 19 Noridian officers and directors in connection with an ongoing full-scope financial examination of NMIC that was in process by other examiners on behalf of the Department. Invotex was also provided access to the other examiners' working papers in order to determine if information contained therein would be useful in the evaluation by Invotex of Noridian's cost allocations.
- Review of documentation from Noridian relating to the design and functionality of the cost allocation system, support for cost allocation calculations including underlying data, and Internal Audit reports.
- Analysis of cost allocations made by Noridian through the development and use of an expense allocation database of downloads of data from Noridian's general ledger.
- Walk-throughs of Noridian's cost allocation processes to develop an understanding about the processes and related controls and to assess whether those controls appeared to be effectively operating as intended.
- Substantive testing of a cross section of Noridian's allocation methods.

In addition to the foregoing procedures, Invotex also reviewed the work and/or reports of others to determine whether their findings or conclusions would impact the evaluation of the cost allocation methodology, processes, or related risks and controls at Noridian:

- Invotex met with members of Noridian's Internal Audit department to assess the work that it performed in auditing cost allocations in 2008 and 2009. *See Pages 48-50.*
- Invotex met with members of Noridian's Internal Audit department to assess NMIC's progress in implementing the applicable provisions of the State's Annual Financial Reporting Model Regulation ("AFRMR") to determine whether those efforts covered cost allocations and, if so, the degree of reliance that could be placed thereon to support controls over those allocations. *See Pages 51-52.*
- Invotex requested and reviewed copies of all work papers resulting from the independent audit of NMIC's 2009 statutory-basis financial statements performed by Eide Bailly LLP, and interviewed the assigned audit partner. *See Page 53.*
- Noridian recently engaged Deloitte Consulting, LLP ("Deloitte") to perform an "allocations review," primarily relating to cost allocations between NMIC and Noridian Administrative Services, LLC ("NAS"). Invotex requested and reviewed a copy of their report. *See Pages 54-55.*
- Invotex requested and reviewed Federal Government Audit Reports covering Noridian's cost allocations, specifically reports of the Defense Contract Audit Agency ("DCAA") and Department of Health and Human Services ("DHHS") on their audits conducted during the examination period. *See Pages 56-58.*
- NMIC participates in an annual study, the Sherlock Expense Evaluation Report ("Sherlock Report"), comparing its functional expenses to those of its peers comprised of

similar-sized Blue Cross and Blue Shield plans and other independent and provider-sponsored plans. Invotex requested and reviewed the survey results and the underlying data and approach. *See Pages 59-61.*

Invotex also requested and reviewed reports of audits conducted by North Dakota Public Employees Retirement System (“NDPERS”) and other large employer groups or national accounts of Noridian during the examination period. NDPERS is the single largest employer group served by Noridian, representing 12% of its overall membership. However, the audit reports of NDPERS and other large employer groups provided to us were focused on the accuracy and timeliness of claims payment; there were no observations or findings documented therein regarding cost allocations.

Invotex subjected information and data obtained from Noridian to testing in order to determine whether:

- The methods used by Noridian to allocate cost center expenses are fair and reasonable for a given cost center.
- The cost center allocation percentages applied to subsidiaries, affiliates and business units by cost center result in reasonable values for their respective share of goods and services provided.
- Functional cost studies identify and support the reasonableness of expenses allocated by business unit and legal entity attributable to self-funded v. fully insured blocks of business.
- Cost allocations made to subsidiaries, affiliates and business units during the examination period are fair and reasonable and are performed in accordance with filed and approved intercompany and affiliated entity agreements.

Invotex selected 2008 as the “base year” for the performance of certain analytical procedures and transaction testing. Due to the timing of the 2009 Target Financial Examination performed by the Department, and as a result of certain resulting organizational and policy changes instituted at Noridian during the past two years, 2008 was chosen because the activities, processes, procedures and controls examined would best represent the environment at Noridian during the overall 5-year examination period.

<p>For ease in locating key findings and recommendations throughout this report, they have been placed in text boxes, as was done for this paragraph. They also appear as a combined listing beginning on <b>page 1</b> of this report. <i>Corresponding recommendations are then shown in italics, like this.</i></p>
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The Prior Target Financial Examination: Noridian was the subject of a prior Target Financial Examination that was performed by the Department; the report thereon was issued as of July 2009. In that report, the Department’s examiners presented evidence indicating that, among other matters, Noridian was not acting in the best interests of its membership as required for a nonprofit mutual insurance company operating in North Dakota.

Specifically, in North Dakota Insurance Commissioner Adam Hamm's letter of September 2, 2009 to NMIC Board of Directors Chairman Dennis J. Elbert and NMIC President and CEO Paul Von Ebers, the following directives were made:

- Noridian's Board should "adopt and implement stricter standards in all matters of BCBS operations, human resources and financial management to ensure that the organization is managed for the good of its members."
- Compensation: "The Board should revise the organization's policies to ensure that the salary and benefits structure is based on the North Dakota market for North Dakota employees, and that incentives are performance-based with meaningful measures for improved performance. Also, the board should enact policies to eliminate unreasonable expenses regarding retirement parties, gifts, luncheons, banquets and other similar expenses."
- Travel Policies: "The Board should enact policies to eliminate (a) expenses categorized as over the approved government per diem, (b) expenses that are not allowed by government, and (c) travel by charter aircraft except where cost savings is documented. The Board should also enact policies to reduce nonessential travel and out-of-state meetings."
- Investments: "The Board, and its Finance and Investment Committee, should revise the organization's policies and implement clear guidelines to ensure that proposed investments are thoroughly scrutinized to identify the risk exposure and any potential obligations."
- Severance Packages and Termination Policies: "The board should enact policies to eliminate severance packages that are not a legal obligation, and to provide for a written termination/resignation policy that is fair and equitable across executive and non-executive positions."

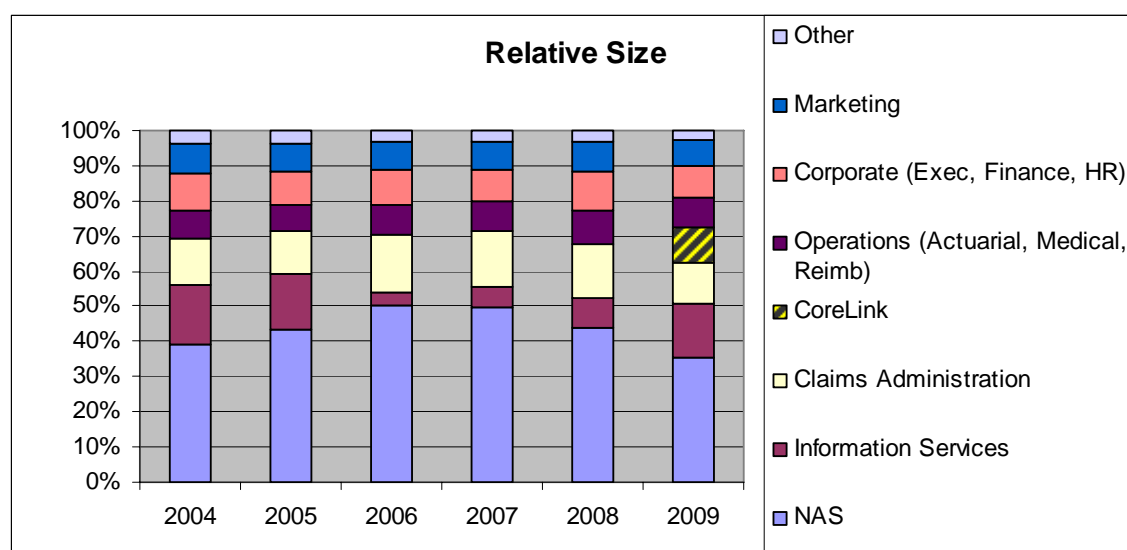
NMIC's response, dated October 2, 2009, outlined actions taken to address each of the Commissioner's directives.

## Noridian's Cost Allocations – Amounts Reported

**Allocations by Division:** The following chart summarizes costs incurred by Noridian as allocated to its various divisions for 2004 through 2009, net of service center allocations:

Division	Gross Operating Expenses in Thousands					
	2004	2005	2006	2007	2008	2009
Actuarial & Membership Services	\$ 5,477	\$ 5,735	\$ 8,251	\$ 8,789	\$ 8,670	\$ 6,925
Affiliates	2,142	2,128	2,705	1,892	1,871	1,937
Claims Administration	22,462	23,247	36,306	39,427	36,443	29,754
Compliance, Audit & Corp Ethics	1,229	1,564	1,574	2,616	1,819	1,688
CoreLink	-	-	-	-	-	27,125
Corporate Services	5,726	6,127	6,469	5,708	4,777	4,994
Development & Business Strategy	1,769	1,831	2,350	2,658	7,276	2,767
Executive	3,212	3,093	3,185	3,701	4,006	6,363
Finance	4,141	3,884	5,186	5,230	5,325	6,128
General Counsel & Facilities	2,799	3,018	2,701	2,912	3,491	2,989
Health Operations	472	478	614	665	799	815
Human Resources & Development	3,132	3,213	4,491	4,893	4,165	4,210
Information Services	28,937	30,626	8,346	14,506	19,329	40,313
Marketing	13,569	14,879	17,384	19,108	19,298	18,709
Medical Management	4,190	3,881	5,252	5,917	7,654	9,098
NAS	66,131	82,154	110,583	121,809	102,369	93,320
Provider Relations & Reimbursement	3,838	4,209	5,564	6,033	6,138	5,369
<b>Total</b>	<b>\$ 169,226</b>	<b>\$ 190,067</b>	<b>\$ 220,961</b>	<b>\$ 245,863</b>	<b>\$ 233,430</b>	<b>\$ 262,503</b>

The chart below shows the relative magnitude of those divisional expenses as a percentage of total gross operating expenses for each of the years under examination. In this chart, only the more significant Divisions are shown separately with the remainder combined in the “other” category.



As reflected in the chart above, the percentages of total costs allocated to certain functional areas such as Information Services, NAS and Claims Administration have varied more widely over the subject examination period. Noridian's management explained that in those specific instances the

variations resulted from organizational changes over the course of the examination period. For example, a series of Information Services (“IS”) service centers were created in 2006 to comply with federal cost accounting standards (“CAS”) as required by NAS for Medicare Administration Contracts (“MAC”) for Durable Medical Equipment, resulting in a relative shift of expenses from the IS division to NAS.

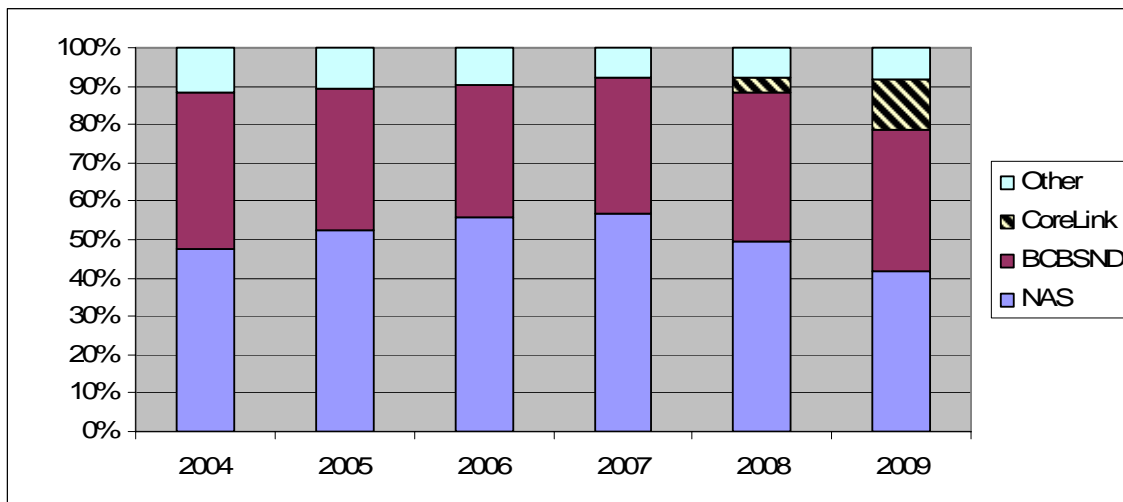
Net IS costs then increased dramatically in 2009 after the creation of Corelink Administrative Solutions (“CoreLink”) and as a result of the chargeback to NMIC for costs relating to programming and processing support services provided by CoreLink on NMIC’s behalf. Similar shifts of expenses resulted from the purchase and integration of Noridian Benefit Plan Administrators (“NBPA”) into NMIC and other smaller organizational changes.

**Allocations by Entity:** Noridian also allocates expenses to lines of business within NMIC and also to NMIC’s operating subsidiaries and affiliates. The end result of that part of the allocation process for each of the years covered by the examination is summarized below:

Entity	Gross Operating Expenses in Thousands					
	2004	2005	2006	2007	2008	2009
BCBSND	\$ 68,412	\$ 70,138	\$ 76,614	\$ 87,282	\$ 90,683	\$ 96,763
Caring Program	204	317	396	320	357	584
CBI/NBPA	1,035	1,569	1,622	2,002	1,667	1,622
CHAND	270	328	365	472	379	430
CoreLink	-	8	0	607	8,595	34,989
Dental Service Corporation	4,307	3,909	4,146	4,334	4,405	4,381
Discovery Benefits	-	-	-	-	396	849
Lincoln Mutual Life	2,037	2,052	2,416	1,967	2,016	2,088
NAS	80,912	99,739	123,181	139,050	115,505	109,187
NBPA	3,363	3,380	3,735	852	601	588
NISI	1,675	1,938	2,340	2,556	2,514	2,732
Non-Op	6,327	5,913	5,218	5,383	5,196	7,139
Vision Services Inc.	684	777	931	1,039	1,116	1,152
	<u>\$ 169,226</u>	<u>\$ 190,067</u>	<u>\$ 220,961</u>	<u>\$ 245,863</u>	<u>\$ 233,430</u>	<u>\$ 262,503</u>

These entity-level expense allocations expressed as a percentage of total gross operating expenses for each year under examination are shown in the following chart. In this chart, only the more significant entities are shown separately with the remainder combined in the “other” category.

**Relative Share of Total Gross Operating Expenses, by Affiliate**



As can be seen above, a large majority of expenses are borne by NMIC (a/k/a “BCBSND” as used in the chart, for Blue Cross and Blue Shield of North Dakota) and by NAS. In the case of NAS, such expenses are primarily related to its payroll which is administered and initially funded by NMIC, then settled between those two entities through direct allocations.

There was a notable drop in the expenses allocated to NMIC and NAS in 2009, with a corresponding increase to CoreLink, a newer entity at the time. While not shown in the table, revenue attributable to CoreLink-related activities, both from NMIC and from external parties, is also allocated to CoreLink. Additional information about Corelink is included later in this section.

**Description of Entities and their Activities:** Of the \$233.4 million of expenses incurred by Noridian in 2008, \$90.7 million was charged to NMIC’s operating expenses. The balance of the expenses were allocated to NMIC’s subsidiaries or affiliates, or classified elsewhere within the NMIC statement of operations, as follows:

**Noridian Mutual Insurance Company  
2008 Operating Expense Summary**

Noridian Mutual Insurance Company	\$	90,683,270
<u>Subsidiaries:</u>		
NAS Direct Assignment		101,650,252
NAS Information Services		2,216,617
NAS Corporate Overhead Allocation		11,637,663
NISI		2,514,084
Discovery Benefits		395,828
CoreLink		8,595,249
<u>Affiliates:</u>		
North Dakota Caring Foundation		356,940
CHAND		378,983
NBPA		2,268,215
Dental Services Corp.		4,405,448
Vision Services Inc.		1,115,622
Lincoln Mutual Life		2,015,693
<u>Non-Operating:</u>		
Wyoming		3,745,882
Investment Expenses		1,310,796
TriCare		448,548
PrimeScript		331
Print Services		(309,442)
Total	\$	<u>233,429,979</u>

**Noridian Administrative Services, LLC (“NAS”)**: NAS is a wholly-owned subsidiary of NMIC and shares many common facilities, services and systems with NMIC.

Charges from NMIC to NAS totaled \$115.5 million in 2008, of which \$103.9 million is the pass-through of expenses incurred directly for NAS’ benefit but which were initially paid for by NMIC, primarily payroll and related employee benefit charges.

*If Noridian plans to continue to administer NAS’ payroll and benefits programs, we recommend the disbursements be made directly out of a NAS bank account. This approach would significantly reduce the amount of expenses borne initially by NMIC, only to be allocated to, and later reimbursed by, NAS. This method would provide more transparency with respect to NMIC’s financial support of NAS; to the extent NAS might need future financial support from NMIC, such support would then no longer flow through intercompany allocations in the ordinary course of business, rather it would take some other form, e.g., a surplus note, capital contribution, or other means that would be more explicit and possibly require the Department’s approval.*

The NAS corporate overhead allocation for the past several years is summarized as follows:

**NAS Corporate Overhead Allocations**

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Information Services	\$ 1,725,347	\$ 4,184,903	\$ 4,571,233	\$ 6,453,941
Human Resources & Training	2,315,816	3,512,110	2,458,101	2,247,156
Executive	596,940	1,178,791	1,330,242	1,845,438
Finance	1,570,824	1,700,210	1,302,851	1,243,203
Communications	635,946	578,723	482,069	613,525
Audit/Compliance	677,592	1,083,850	967,953	368,616
Medicare Compliance	-	671,150	-	-
General Counsel/Legal	137,503	439,449	166,936	61,363
Facilities	507,561	369,756	263,015	192,387
Actuarial	41,274	42,479	31,992	40,983
Medical Management	19,934	26,195	37,645	11,695
Other	91,631	56,735	25,626	61,812
Total	<u>\$ 8,320,368</u>	<u>\$ 13,844,352</u>	<u>\$ 11,637,663</u>	<u>\$ 13,140,119</u>

Additional information about the more significant of the overhead areas follows:

Information Services: Information Services allocations grew significantly from 2006 to 2009 and was driven primarily by allocations for shared mainframe computer systems and related software. These costs are allocated largely based on the number of employees.

Human Resources & Training (“HR”): Allocations for these services have been relatively consistent over the past several years, with the exception of a temporary spike in 2007 which attributed to direct NAS HR expenses. All other HR and related allocations are based upon actual employee counts.

Executive: Executive allocations to NAS have increased considerably over the past several years, as illustrated below:

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Executive:				
601 Board & Corporate Expense	\$ 74,618	\$ 92,309	\$ 95,529	\$ 97,443
611 President/CEO BCBSND	324,479	377,128	451,549	965,358
671 Exec VP Health Operations	87,130	110,314	96,130	156,668
801 EVP Corporate & Govt Operations	110,713	599,041	687,034	625,970
	<u>\$ 596,940</u>	<u>\$ 1,178,791</u>	<u>\$ 1,330,242</u>	<u>\$ 1,845,438</u>

While the nominal amounts of the allocation of these cost centers to NAS has increased significantly, NAS’ share of total incurred expense for these cost centers, with the exception of cost center 801 EVP Corporate & Government Operations, has been relatively stable at approximately 13% of the total. The Executive Vice President of Corporate and Government Operations has direct oversight and responsibility for the operations of NAS.

Accounting & Finance: Allocations to NAS for accounting and finance services from NMIC have been consistent both nominally and on a relative basis over the past several years. The allocation methodologies employed are consistent with those used for allocations to the lines of business within NMIC.

Expense allocations to NAS appear to be reasonable. Direct assignment of expenses to NAS is used extensively. The allocation of shared information services expenses and corporate overhead is based on appropriate allocations methodologies that are applied consistently throughout the organization.

**Noridian Insurance Services Inc. (“NISI”):** NISI is owned jointly by NMIC (94% interest) and by affiliate Lincoln Mutual Life and Casualty Insurance Company (6% interest). NISI operates as an insurance agency marketing a variety of supplemental group products and other employee benefits that are not underwritten by Noridian.

NMIC provides administrative and related services to NISI under various agreements. Expense allocations for these services totaled \$2.5 million in 2008. Of this total, \$2.1 million represents allocations from the Marketing division. Another \$0.1 million represents direct expenses related to the NISI board and related corporate expenses. These expenses flow through non-operating income, and NMIC is fully reimbursed by NISI for these costs.

**Discovery Benefits, Inc. (“DBI”):** NMIC has a 51% interest in this joint venture, an employee benefits administrator; State Street Bank and Trust is the minority shareholder. DBI provides employee benefits administration for flexible benefits, health reimbursement arrangements (HRA), health savings accounts (HSA), COBRA and transportation-related fringe benefits. DBI is an active entity that is almost entirely self-contained. Thus allocations from NMIC are minimal. Total expenses charged to DBI for 2008 were just under \$400,000, the majority of which was charged from one cost center established to capture DBI-related information services and other direct expenses incurred on behalf of DBI.

**CoreLink Administrative Solutions, LLC (CoreLink):** CoreLink was established effective January 1, 2009 as a joint venture between NMIC and Blue Cross Blue Shield of Nebraska, with each holding an equal 50% ownership interest. CoreLink was formed as a healthcare technology company to provide membership and claims processing services to both its owners as well as to other health insurers, health maintenance organizations and managed care entities.

Expenses totaling \$8.6 million were identified and allocated to CoreLink in 2008. These costs were initially charged to non-operating income, though most were then capitalized as part of the investment in the new joint venture. As a new venture, there is no prior data to view for comparative purposes.

The establishment of CoreLink caused a significant reorganization of Noridian’s Corporate Structure. CoreLink’s 2009 expenses totaled \$35 million, much of which is direct assignment of expenses from the newly established CoreLink “division” set of cost centers that exists on NMIC’s books and records. Allocations of corporate overhead to Corelink are consistent with allocations to NAS and other lines of business within NMIC.

**North Dakota Caring Foundation:** This entity was established by NMIC in 1989 as a not for profit, public 501(C)(3) organization to administer Caring for Children, a program that connects

the state's uninsured children with medical, dental and mental healthcare providers at no cost to their families. NMIC provides all administrative support for the function.

North Dakota Caring Foundation's operating expenses for 2008 were \$356,940, most of which are direct charges from two cost centers established to administer this program. Allocations from other functional areas and support services cost centers are immaterial. All of these expenses are charged to non-operating income and expense.

**Comprehensive Health Association of North Dakota ("CHAND"):** CHAND is a not-for-profit corporation that is a legislatively created entity and regulated by the Department. CHAND makes health coverage available, through NMIC, to residents of North Dakota who have been denied health insurance or who otherwise have restricted coverage due to health problems or who were considered to be in a high risk category.

Operating expenses allocated by NMIC to CHAND totaled \$378,983 in 2008 and include claims, underwriting, membership, information services and medical management costs. An internal program specialist devotes most of his time to the CHAND program.

As the lead carrier, NMIC administers this program and is fully reimbursed for the related expenses incurred. Both the expenses and the reimbursements flow through non-operating income. Allocations to CHAND follow the standard expense allocation methodologies employed for all other line of business allocations.

**Noridian Benefit Plan Administration ("NBPA"):** NMIC acquired a third party administrator that services certain non-medical flexible benefits and pension administration services. The medical insurance portion of this block of business was purchased by Noridian and consolidated with NMIC effective January 1, 2007. Therefore, the continuing third-party administration services are now handled by NMIC directly; however, for NMIC's internal purposes these activities are collectively referred to as "NBPA" notwithstanding that they are no longer housed in a separate entity or department.

Administrative expenses allocated to NBPA totaled just under \$2.3 million for 2008 and were charged to Non-Operating Income. Most of this expense represents direct costs incurred for claims administration and for NBPA's district office operating costs.

Net non-operating revenue generated through these services was almost \$1.5 million in 2008, resulting in a net loss of approximately \$800,000.

**Dental Services Corporation of North Dakota ("DSC"):** DSC is a not-for-profit corporation owned by participating providers. NMIC provides administration services to DSC based on a contractual agreement. DSC has no employees. In 2008, NMIC incurred \$4.4 million of expenses which were allocated to DSC for 2008 and was fully reimbursed by DSC. Most of the expense total represents claims, actuarial and marketing costs. All allocations to DSC follow the same methodology used for allocating expenses among all other NMIC lines of business.

**North Dakota Vision Services, Incorporated ("VSI"):** Similar to the structure of DSC, VSI is a not-for-profit corporation owned by participating providers, with NMIC providing

administrative services based on a contractual agreement. VSI has no employees. All of the \$1.1 million of expense allocations to VSI for 2008 have been fully reimbursed by VSI. All cost allocations to VSI follow the same methodology used for allocating expenses among NMIC's other lines of business.

**Lincoln Mutual Life and Casualty Insurance Company ("LML"):** LML is a mutual insurance company managed and controlled by NMIC. NMIC has 12 full time employees that perform functions for LML. NMIC has established a series of cost centers to accumulate costs that are solely devoted to LML operations and is fully reimbursed for expenses that it has incurred on behalf of LML.

**Blue Cross Blue Shield of Wyoming ("Wyoming"):** NMIC performs third-party administrative services for Wyoming on a contractual basis. These services primarily consist of claims processing and membership data administration. Expenses totaling \$3.7 million were charged to non-operating income for 2008 against the contract with Wyoming. These expenses were more than offset by revenues totaling just over \$4.1 million for the year.

Wyoming-related expenses include charges from claims processing, actuarial membership services and management information, medical management information and technology support. The expense allocation methodology employed in support of the Wyoming contract is consistent with the approach used for allocating expenses to internal lines of business.

**Costs Allocated by Allocation Method or Basis:** The chart below summarizes 2008 expense totals by the 27 allocation methods and /or bases utilized by Noridian.

<u>Allocation Method or Basis</u>	<u>2008</u>	<u>% of Total</u>	<u>Cumulative</u>
1 - Direct	\$ 121,072,420	51.9%	51.9%
2 - Claims Count	23,214,152	9.9%	61.8%
3 - Time Survey	22,461,337	9.6%	71.4%
4 - Employee Count	20,282,321	8.7%	80.1%
5 - Weighted Contract Count	14,655,487	6.3%	86.4%
6 - Member Contact Incidents	5,729,345	2.5%	88.9%
7 - Labor Dollar	4,976,696	2.1%	91.0%
8 - Contract Count	4,161,552	1.8%	92.8%
9 - Salary Ratio	4,116,875	1.8%	94.5%
10 - Machine Time	3,812,178	1.6%	96.2%
11 - Income Ratio	2,305,336	1.0%	97.2%
12 - System usage by company/claims	1,812,115	0.8%	97.9%
13 - # of THOR Sites	1,346,642	0.6%	98.5%
14 - Total \$ of cc spvsd - Comm. Div.	419,663	0.2%	98.7%
15 - CARS/Printer/Microfilm Totals Rpts	412,274	0.2%	98.9%
16 - BPA Participant Count	412,050	0.2%	99.0%
17 - # of Requisitions	390,345	0.2%	99.2%
18 - Total Operating Expense by LOB	362,973	0.2%	99.4%
19 - Accessible Storage Report	258,733	0.1%	99.5%
20 - Number of Tapes	257,299	0.1%	99.6%
21 - Claims Volume	250,011	0.1%	99.7%
22 - Members Ratio	164,332	0.1%	99.8%
23 - # of ID Cards Printed	160,802	0.1%	99.8%
24 - # of CALLIGO Users	124,167	0.1%	99.9%
25 - # of Devices in Call Center	119,631	0.1%	99.9%
26 - # of Claim pages scanned per LOB	50,641	0.0%	100.0%
27 - # of Users per cost center	48,721	0.0%	100.0%
28 - # of Items Processed/Income	44,742	0.0%	100.0%
29 - # of LAN Connections	4,739	0.0%	100.0%
30 - Storage space	2,402	0.0%	100.0%
	<u>\$ 233,429,979</u>	<u>100.0%</u>	

As can be seen from the chart above, approximately \$121 million or 52% of expenses are classified as direct, i.e., these are costs that are specifically attributable and charged to a cost center and therefore are not subject to an experience-based allocation process. Costs that are subject to an allocation process are primarily allocated on the basis of claims count, time survey, employee count, contract counts and contact incidents, with other allocation bases used to much lesser degrees.

The vast majority of the expenses directly charged to a cost objective are in support of NAS. Although NAS operates largely independent from NMIC, NAS does rely on NMIC for certain services, most notably, payroll. The pass-through of expenses from NMIC to NAS includes salary, benefits, payroll taxes, rent and a number of shared services.

The table below shows 2008 expenses subject to allocation processes, i.e., it is the same as the prior table except that it excludes the direct charges other than to reconcile in total at the bottom of the table:

<u>Allocation Method or Basis</u>	<u>2008</u>	<u>% of Total</u>	<u>Cumulative</u>
2 - Claims Count	\$ 23,214,152	20.7%	20.7%
3 - Time Survey	22,461,337	20.0%	40.7%
4 - Employee Count	20,282,321	18.1%	58.7%
5 - Weighted Contract Count	14,655,487	13.0%	71.7%
6 - Member Contact Incidents	5,729,345	5.1%	76.8%
7 - Labor Dollar	4,976,696	4.4%	81.3%
8 - Contract Count	4,161,552	3.7%	85.0%
9 - Salary Ratio	4,116,875	3.7%	88.6%
10 - Machine Time	3,812,178	3.4%	92.0%
11 - Income Ratio	2,305,336	2.1%	94.1%
12 - System usage by company/claims	1,812,115	1.6%	95.7%
13 - # of THOR Sites	1,346,642	1.2%	96.9%
14 - Total \$ of cc spvsd - Comm. Div.	419,663	0.4%	97.3%
15 - CARS/Printer/Microfilm Totals Rpts	412,274	0.4%	97.6%
16 - BPA Participant Count	412,050	0.4%	98.0%
17 - # of Requisitions	390,345	0.3%	98.4%
18 - Total Operating Expense by LOB	362,973	0.3%	98.7%
Other	1,486,220	1.3%	100.0%
Subtotal	112,357,559	100.0%	
1 - Direct	121,072,420		
Total	\$ 233,429,979		

The above table shows that 92.0% of the expenses subject to an experience-based allocation process are allocated based on only nine allocation bases or methods. The target examination therefore focused more heavily on those methods.

#### Description of the Primary Allocation Bases Used by Noridian

The various allocation bases used by Noridian are, for the most part, as recommended by BCBSA as guidelines for its members; such methods were developed in the years following the introduction of Medicare by BCBSA working groups as an informal endeavor and with little formal documentation. The documentation of such methods that is available at NMIC consists of a single binder that has not been updated in over 20 years. Noridian has, in some instances over the years, modified those BCBSA-recommended allocation methods or adopted alternate methods to meet specific needs.

*Noridian should take such steps as are necessary to ensure that key aspects of its cost allocation process are adequately documented and up-to-date. This would include the rationale behind the selection of various allocation bases, a description of the underlying process, and related controls.*

Claims Count Allocations: The use of claim processing activity metrics for the allocation of most claims administration expenses is a common and accepted practice in the insurance industry. In the absence of a system that can calculate the exact amount of time and expense incurred at the individual claim level, the use of claim processing activity as an allocation basis is a reasonable approach. The use of LOB and activity-specific cost centers improves allocation precision by allocating smaller pools of claim administration expense over more targeted groups of claim payments statistics. Noridian has developed a cost center structure that utilizes to a large degree the direct charge approach for claims-related expense and which results in a significant level of homogenization of claims related expenses; where allocation is required of claims-related expense, it uses objective claim count data.

Claims count statistics were used as the basis to allocate \$23.2 million of operating expenses in 2008, 97% of which represents expenses incurred within the Claims Administration division. The balance represents claims adjudication-related expenses managed directly by the Information Systems, Actuarial and Medical Management divisions.

Not all of Noridian's Claims Administration division expenses are allocated based on claim counts; another \$13 million of Claims Administration division expenses in 2008 were allocated based on other measures, e.g., statistics derived from member contacts and communications with the Member Services Department, time surveys used for certain information systems costs, and the direct assignment of expenses to Line of Business ("LOB") codes.

Noridian allocated the expenses of 33 cost centers based on claim counts in 2008. About half of the cost centers are dedicated to pure claims processing and related member service activities. Separate cost centers are used to segregate the expenses of certain lines of business, including Federal Employee Program ("FEP"), NDPERS, Dental, Vision and Pharmacy. There also is a series of cost centers dedicated to information technology support of the various claims processing systems.

Claim counts (numbers of claims processed) should be used where the costs of processing the average claim does not vary significantly with the size of a claim. Claim values (the dollar value of claims) would be more appropriate in instances where the value of a claim significantly impacts the resources required for its adjudication. For example, costs related to pre-certification of coverage for medical procedures generally relate to surgical and other more expensive procedures. However, Noridian uses claim counts for the allocation of expenses associated with Medical Necessity Reviews and pre-certification authorizations.

*Noridian should investigate the feasibility of measuring actual case-level statistics to more accurately allocate expenses associated with Medical Necessity Reviews and pre-certification costs to lines of business, weighing the cost of such a change against the value of the improved allocation precision.*

Time Survey: Time survey refers to an automated time reporting system in which employees (or contractors, if applicable) code actual time worked into a reporting database. The time reporting codes can represent direct charges to lines of business, or charges to pre-defined projects or

activities. The pre-defined projects or activities are, in turn, mapped to lines of business based on the nature of the work.

Time survey is an effective way to facilitate dynamic expense allocations provided that activity and project codes are well-defined and properly mapped to cost objectives.

At Noridian, time survey is the second most widely used allocation methodology, accounting for \$22.5 million of allocated expenses in 2008, or 20% of the total gross operating expenses subject to allocation.

The use of time surveys is most often associated with the tracking of information technology costs and also is appropriate for functional areas in which the work tends to be project-related or where the ultimate consumer of the services varies considerably on a daily, weekly or monthly basis. Noridian employs time surveys for a number of activities occurring across all divisions.

Noridian's largest internal users of the time survey methodology include Medical Management (preauthorization and case management services), Business Systems, Member Services and MIS, areas that operate in a project-like environment.

Employee Count: Employee counts are used as an allocation basis for both cost center and service center level allocations. Service center allocations are discussed in the Noridian's Cost Allocation Methodology and Related Processes section of this report, beginning on **page 28**.

Noridian uses the employee count method most frequently for the allocation of expenses of supervisory-level employees. This would include supervisors, managers, assistant vice-presidents and other levels of management. The allocation percentages for these supervisory cost centers are derived from the allocations methods in place for the employees they oversee. In other words, the calculation is a weighted average of the allocation percentages of all cost centers under management, with the weighting based on the number of employees within each cost center.

The use of employee counts as an allocation basis is appropriate when the compensation levels of the employees in the pooled allocation base group do not vary significantly. Salary dollar-based allocation methods are generally employed by Noridian in instances where the pooled salary levels are more dispersed.

For 2008, \$20.2 million or 18.1% of total allocated expenses were calculated using the employee count method.

This method is also used to allocate certain other expenses that benefit all employees equally, e.g., costs relating to certain Human Resources functions and shared applications or systems.

Weighted Contract Count: The Weighted Contract Count method is used primarily for the allocation of Marketing division expenses. For 2008, \$14.6 million or 13% of allocated cost center expenses were allocated utilizing this methodology. In this approach, two sets of allocation percentages are calculated, one based upon contract counts by LOB and one based

upon premium by LOB. The average of these two set of percentages are used as the basis for the cost center allocation.

For some cost centers, in particular those marketing cost centers with subsidiary or affiliate allocations, the calculation was adjusted to ensure that only 85% of the expense total would be charged to NMIC's lines of business, with the remaining 15% charged to affiliates and subsidiaries supported by that department.

Noridian's Director of Finance represented to Invotex that this adjusted approach was developed in early 2004 following the line of business reorganization that combined the institutional and professional lines of business; that due to the mechanics of the allocation methodology in place, the reorganization resulted in a higher level of charge to certain affiliates; that an expense study was performed at that time resulting in the 85%/15% allocation split that is still in place today; and that the higher level of expense allocation to affiliates was validated at the time and phased-in over a 5 year period due to the significance of the changes.

Noridian's use of contract counts and/or premium may be reasonable allocation bases for many marketing costs; however, the 85%/15% allocation to NMIC and its subsidiaries, respectively, involves documentation that is inadequate and out-of-date, and does not provide support for management's decision to phase-in the impact of changes made to the process.

*Noridian should document its reasoning as to why an average of contract counts and premium is appropriate. It should also document the basis for the 85% NMIC weighting that has been in place since 2004. Given that the 2004 study referenced by management involves some level of subjectivity, this study should be updated on a regular basis to ensure key assumptions remain valid. Additionally, in the future, Noridian should not phase-in corrections to allocation processes; rather, they should be implemented immediately.*

Member Contacts: The number of contacts refers to actual encounters with policyholders or healthcare service providers in the performance of customer or provider service activities. Noridian maintains an automated tracking system that accumulates statistics on these activities for a variety of reasons. Such contacts include member telephone calls, face to face discussions (walk-ins), electronic mail, regular mail or other means. Expenses are allocated to lines of business based on the relative percentage of contacts for each line of business tracked by the Company. Weightings are assigned to each contact type to better reflect the relative amount of time and expense incurred. This method was used to allocate expenses for four cost centers with 2008 expenses totaling \$5.7 million.

Labor Dollar: Labor dollar refers to the allocation of certain cost center expenses based upon the aggregate allocation of salary and related benefit costs of the entire organization. In some instances, the labor dollar allocation results are adjusted by Noridian's management. Labor dollar is an indirect allocation methodology used primarily for certain corporate functions including the President/CEO, certain legal functions and government relations. For 2008, a total of \$5.0 million was allocated based on labor dollars.

Invotex's analysis of Noridian's use of the labor dollar method revealed significant variability among the cost centers employing this method. While one would not expect the percentages to

be the same due to the possibility of direct assignment of certain transactions and the different pattern of monthly incurred expenses among the labor dollar cost centers, some consistency would be expected.

Noridian's management asserted that there are different subsets of labor dollars used for each cost center, and that other adjustments are made based upon the nature of the department; that for cost center 0611 (President & CEO), the labor dollar allocation was adjusted by reducing the charges to affiliates by 50%, with a proportional increase to the allocations to NMIC's lines of business. However, documentation to support this adjustment was not available. According to the Director of Finance, this factor was based on an estimate provided by the previous President & CEO.

NMIC's executives have in the past used some "top-level adjustments" to alter cost allocation results. While many companies occasionally use top-level adjustments as an element of financial reporting, those adjustments should be subject to strong internal controls because of the small number of very high-level individuals who are involved and the opportunity for conflicts of interest, as well as the by-passing of customary controls.

*Where possible, the use of top-level adjustments in the allocation process should be avoided; if that is not possible, then those top-level adjustments that do occur should be well-documented and with explicit documented approvals of qualified senior executives and with notice to Internal Audit. Upon subsequent investigation, Internal Audit should report their findings not just to NMIC, but also to the boards of other affiliates whose allocations have been impacted by these top-level adjustments.*

Contract Count: Many specific functions within the Membership and Underwriting cost centers cannot be attributed to individual contracts, and are therefore allocated based on the relative number of contracts for each LOB/entity. Contract count is a statistical allocation method whereby certain expenses are allocated to lines of business based on the number of insurance contracts in force. Contract counts are used by Noridian primarily for the allocation of actuarial membership and underwriting functions and certain information services costs associated with group insurance contract issuance and renewal. A total of \$4.2 million was allocated based on contract counts in 2008.

Salary Ratio: Salary ratio is used primarily by senior management to allocate expenses based on ratios calculated by examining the salary and related employee benefit expense allocations of the employees managed by that individual. Rather than looking to the company-wide allocations of salary and benefits (labor dollar approach), this method bases the allocation percentages on a smaller group of cost centers for which an individual manager is responsible. Salary ratio is most appropriate where the cost centers supervised contain a wide range of salary levels. In 2008, \$4.1 million or 3.7% of allocated expenses were calculated using this method.

Machine Time: Machine time refers to the allocation of certain information services costs based on actual computer processing time statistics. Noridian uses machine time to allocate all costs associated with its mainframe system, including backup systems. For 2008, this represented the expenses of five cost centers with expenditures totaling \$3.8 million (3.4% of allocated cost center expenses).

## Noridian's Cost Allocation Policy and Related Governance

Formal written cost allocation policies are helpful in setting forth the objectives of a cost allocation scheme and underlying principles so as to better assure a uniform understanding across the enterprise; stating in reasonable and sufficient detail corporate policy so as to facilitate uniform implementation and maintenance and in accordance with applicable cost accounting standards and regulatory requirements; and in providing those charged with the design, implementation and/or maintenance of related practices or related monitoring or governance over cost allocations with authoritative guidance to help them fulfill their responsibilities more uniformly, consistently and effectively through reference to a single authorized standard.

A formal written cost allocation policy does not exist at Noridian, an issue that has been noted by Noridian's Internal Audit department in a January 2010 report.

*Noridian should take such steps as are necessary to assure that there is adequate written and properly approved documentation supporting the cost allocation function. This would include a formal cost allocation policy and supporting business process documentation. The cost allocation policy should be approved by senior management of NMIC and each of its subsidiaries and affiliates that are subject to the cost allocation process. The cost allocation policy should also be subject to review by the Audit Committee of NMIC inasmuch as cost allocation processes have been identified and reported by Noridian's independent auditor to NMIC's Audit Committee as being among the most sensitive estimates affecting NMIC's financial statements.*

Although NMIC does not currently have a Cost Allocation Policy in place, it appears that may be rectified in the near future. The NMIC Strategic Plan update 2010 – 2013 was presented and discussed at NMIC's Board of Directors meeting on April 23, 2010. In the Strategic Plan document that was included in the Board of Directors package provided to Invotex by NMIC's Internal Audit department, the following objective was assigned to the Chief Financial Officer:

“Continue to review cost allocations to subsidiaries [and] specific lines of business and develop a corporate philosophy around the charging [of] these costs to the same. Improve administrative efficiencies across the enterprise.

- Evaluate shared services between business units to determine if in-sourcing, out-sourcing and/or in-sourcing with process improvements are the best value for the enterprise.
- Lead an initiative to look for administrative efficiencies and develop consistent productivity measures within the BCBS business unit.
- Develop the business case for charging market administrative cost rates to self-funded groups that may or may not be reflective of the fully allocated costs.”

At the request of the department, Invotex specifically reviewed Noridian's current travel and entertainment expense policy.

Noridian's Travel and Entertainment Policy appears to adequately address most procedures for handling of travel expenses. We do note, however, that travelers are not required to report the names and titles of other Company personnel traveling together. Receipts are required for expenditures of \$50 or more. The policy appears to adequately address IRS requirements for documentation. General travel requirements appear adequate with guidance on obtaining the lowest available price with reasonable conditions. Restrictions on the use of business class air travel appear to be reasonable, e.g., with authorization business class travel would be permissible on longer flights. Guidance is provided on per diem rates and restricts reimbursement to such rates. The policy provides reasonable guidance for most situations in which company employees would be required to travel on company business. The policy does not specifically address out-of-state meetings or the use of charter aircraft.

*Invotex recommends more stringent rules for the requirement of receipts for out of pocket expenditures, and we recommend that travelers report the names and titles of other Company personnel traveling together (to facilitate travel expense audits). The policy should also be revised to address out-of-state meetings and the use of charter aircraft.*

## **Noridian’s Cost Allocation Methodology and Related Processes**

As the parent corporation over the Noridian family of companies, NMIC maintains accounts for a pool of expenses on a “gross” or pre-allocation basis that are then allocated to NMIC and to its subsidiaries and affiliates utilizing an allocation methodology as described in the Noridian’s Cost Allocation – Amounts Reported section of this report that begins on **page 12**.

This section describes Invotex’s understanding of Noridian’s cost allocation process and the associated controls. The description of the process is based on available documentation provided by Noridian’s management, supplemented by information obtained during process walk-throughs, meetings and inquiries of Noridian’s management and staff. Accordingly, such information is the representation of Noridian’s management.

Operating expenses for Noridian are initially incurred within three separate legal entities within the Noridian group of companies – NMIC, NAS and Corelink – and are then subject to allocation, i.e., the calculation and reporting of operating expenses by legal entity, line of business and function.

Expenses and allocations for NMIC and Corelink are handled by finance department staff at Noridian’s headquarters in Fargo, ND. On the other hand, NAS operates more autonomously than NMIC’s other subsidiaries and affiliates following the 2007 split of NAS’ operations from NMIC several years ago. NAS maintains its own separate physical location in Fargo as well as its own staff. Among other things, NAS maintains its own general ledger and accounts payable system on a basis separate and apart from NMIC and its other subsidiaries and affiliates.

The Noridian cost allocation process is a multi-tiered approach, the primary objective of which is to assign all expenses incurred across the enterprise to functions, product lines and to the respective legal entity, e.g., NMIC and/or one or more of its subsidiaries and affiliates, as appropriate. This multi-tiered approach is described through a sequential series of steps, described below.

### **Step 1: Record Operating Expenses in the General Ledger by Cost Center**

Operating expenses incurred by NMIC and Corelink are coded in the SmartStream ledger to various cost centers. NAS does the same in its general ledger for costs that it incurs using a ledger package known as Deltek. There were approximately 369 active cost centers in use by NMIC in 2008. Expenses are recorded to the general ledger by manual journal entry (mainly accruals) or by electronic interface. Such electronic interfaces exist for payroll and for accounts payable-related items.

Disbursement vouchers and journal entries permit, but do not require, the direct assignment of an expense to cost centers where such direct assignment is deemed appropriate. To the extent that costs can be readily identifiable to a function /LOB/entity, they are charged directly thereto. Disbursements or entries that are not assigned directly to a cost center are subjected instead to a

cost allocation methodology. Cost allocation methodologies are essentially estimates; they assume that a fair presentation of current costs by function/LOB/entity can be modeled based on past experience that relates cost levels to causal or beneficial relationships. To the extent that more costs are objectively determined to relate to a specific cost center and are directly charged thereto, the less cost there is that is then subject to the estimation process, and the more reliable the results may be. The trade-off is with cost-benefit; at some point, the additional detailed analysis required to objectively determine where to charge a particular cost yields a result that is not significantly better or more reliable than an allocation based on prior experience.

Noridian's Director of Finance maintains a cost allocation database at a cost center level which includes a description of the purpose and nature of each cost center, along with the allocation method utilized. Also maintained is a log of updates or changes made, including a record of when each cost center was last updated. Such a database can comprise an important control feature of the system.

Noridian's cost allocation process documentation does not include the reasoning as to why particular allocation methods were chosen.

*Noridian should update the cost allocation database to document why each allocation method used was deemed to be the most appropriate.*

Allocation systems employing too few cost centers generally subject a larger portion of the expense total to allocation estimation and a form of "modeling risk," i.e., that costs currently being allocated are not similar to those used from past experience to develop the allocation factors. Allocation systems employing too many cost centers may result in improved accuracy, but at the expense of efficiency, often resulting in an unwieldy and/or sub-optimal cost management system.

NMIC's management has represented that NMIC currently reviews its cost center structure on an annual basis and when organizational changes arise; that this process has been in place for several years and has been consistently followed; and that the number of cost centers used by NMIC for allocations is needed to support a more accurate and detailed cost allocation process.

Based upon a review of the nature and function of cost centers in use in 2008 and the changes to the cost center structure over the course of the examination period, Invotex believes that Noridian's cost center structure is adequately designed to support the cost allocation function and that it has reached a reasonable balance in terms of the number of cost centers, erring on the side of conservatism, i.e., there may be too many rather than too few cost centers.

## **Step 2: Allocation of Service Center Expenses**

The first level of Noridian's cost allocation process involves the assignment of "service center" costs to the respective entity's various functional activities.

The service center allocation process in use at Noridian (also known as expense "chargebacks" in many organizations) is designed to eliminate the need to assign service costs directly to lines of business, which could be a very difficult task to accomplish accurately; allow managers of key

functional areas within the organization to understand the cost of services they consume, and, by extension, the ability to better manage those costs; and results in more accurate financial reporting by ensuring that all expenses, regardless of their nature, are ultimately allocated to lines of business based on actual usage and on beneficial or causal relationships using objective statistical data.

Service center allocations transfer 100% of the amounts incurred by a given department to each internal “customer” for those services based on actual usage. The customers are various departments within the insurance company that may perform core functions, e.g., underwriting, claims administration, sales and marketing. A key control in this process is that the internal customers themselves procure the goods or services from the service center and can compare the subsequent charges to their orders; if warranted, they can challenge the volumes consumed or the service rates utilized in order to determine the need for corrections.

There were 369 active cost centers in use by Noridian in 2008. Of those, 94 were classified as service centers and accounted for \$49.1 million or 21% of the \$233.4 million of total gross operating expenses incurred by Noridian for the year.<sup>1</sup> From an accounting standpoint, the service center allocation is accomplished through a series of journal entries typically performed as part of the month-end close. Departments that “purchase” services receive a charge to their cost center, while the service center receives an offsetting credit.<sup>2</sup> At the end of each accounting period, each service department will therefore have a net expense total of \$0. Post-allocation, the total expenses for the 275 non-service cost centers that were used by Noridian in 2008 expense totals sum to the original \$233.4 million.

The design of the service center structure at Noridian appears to be appropriate. However, some departments currently classified as cost centers could be easily converted to service centers. In discussions with Noridian’s management about the matter they agreed, and asserted that additional departments will be converted to services centers over time. This is a resource issue which will result in some internal inconsistencies until completed.

### **Step 3: Allocate Cost Center Expenses**

The 275 non-service cost centers are then subjected to the second level of allocation that assigns every dollar of expense to one of approximately 40 LOB codes. In addition to identifying the LOB, these codes are used in a hierarchy structure to also determine the legal entity to which the expenses are to be charged. The process of assigning all expenses to one or more LOB codes also facilitates internal analysis of expenses and supports the financial reporting process.

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<sup>1</sup> The \$233.4 million includes all of the expenses incurred by NMIC and Corelink in 2008, but only that portion of NAS’ expenses that were allocated to NAS, or by NAS to other entities; it excludes expenses that were incurred by NAS in 2008 and which stayed on NAS’ books.

<sup>2</sup> Noridian’s service department allocation approach results in a net \$0 expense balance for service departments, regardless of service volume. This is a common approach but differs from an approach that employs standard costing, by which rates are fixed and the service department could recover more or less than the amount it actually spends depending upon volume and service department operational efficiencies.

From a process workflow standpoint, there are three categories of expense allocation in place at Noridian, as follows: Direct Assignment; Time and Labor Allocation; and Statistical Allocation. Each of these allocation categories is discussed in more detail below.

### **Direct Assignment**

Certain cost centers, based on the nature of the activities performed, are charged directly to one or more LOB codes. For example, a department that supports only FEP would be charged 100% to the FEP LOB code, which is #120.

Similarly, to the extent certain expenses originate on NMIC's general ledger but are incurred solely in support of a subsidiary, those costs would be allocated to an LOB code that represents that legal entity. NAS is a good example; for 2008, a total of \$233 million of expenses were accumulated on NMIC's SmartStream general ledger, \$121 million of which, or more than half, was allocated on the direct method. Of the \$121 million, \$100 million related to NAS, a significant amount which is primarily attributed to NAS' payroll which is processed by NMIC.

The SmartStream general ledger system also allows for the direct coding of individual transactions to specific LOB codes, thus avoiding the need for the allocation process. However, such direct coding can give rise to inconsistencies in coding inasmuch as individual managerial judgment is applied on a case-by-case basis. It can also result in error or abuse in the absence of adequate controls, a plausible scenario given the lack of documentation over the allocation processes.

The cost center structure is designed to maximize the use of direct assignment. InvoTex found no exceptions to that objective, notwithstanding the lack of a documented cost accounting policy and supporting process documentation.

If NMIC were to continue to process NAS' payroll but did so using NAS' own checking account print stock, then the largest part of the intercompany allocation by far would be eliminated. However, NAS has a payable balance to NMIC, indicating that it may not have the cash resources to pay its own payroll without some form of financial support from NMIC.

### **Time and Labor**

Time and labor refers to allocations that are based on actual labor hours multiplied by a calculated rate. Departments use the time and labor approach to track hours worked on behalf of other departments (i.e., the internal customer). Time is tracked based on a series of labor codes associated with certain tasks an individual might perform. Time and the associated labor codes are input to WorkForce, a work time and attendance tracking system. The resulting hours, multiplied by the hourly rate, produce a charge that is allocated to lines of business based on the allocation method of the associated customer. The rates are dynamically calculated to allocate 100% of actual incurred costs. In other words, there are no volume variances. Employees performing certain functions are required to track their time on a daily basis and to code their

time to applicable cost centers. For 2008, \$23 million of time and labor expense was allocated based on this approach.

There are three sources for the time and labor code information that is fed into WorkForce:

1. Corporate Project Tracking system (Oracle database)

When a corporate project is approved by the project owner a system-generated email is sent requesting the assignment of account charge information for the corporate project. The Director of Finance has primary responsibility for assigning the account charge information. The Sr. Accountant/Analyst and the Accountant II also have access as a back-up to assign this information.

To determine the appropriate account charge number, cost center, line of business or NAS project ID, the Director of Finance or assigned staff review the information provided on the project for the impacted lines of business, divisions, and departments. They also review the objectives and scope sections of the project form. If this information does not provide a clear description of the purpose of the project, direct contact is made with the appropriate DBS analyst and project owner to request additional information regarding the areas of the company that would be impacted by the project.

2. MIS Project Tracking System

MIS, in this context, refers to the Actuarial Management Information Systems group which is separate from Noridian's IT function. MIS project tracking operates similar to the tracking for corporate projects. This database has been in use for a number of years, and pre-dates the establishment of the Corporate Projects function.

3. PeopleSoft (used by Noridian for payroll purposes)

All Noridian employees must log on to the WorkForce system and input their time each week. The processes described above for Corporate Projects and MIS Project Tracking is specific to those employees whose expenses are allocated by time and labor, and thus entails detailed weekly time reporting by "labor code." However, for payroll purposes, all other employees must also input their time and have it approved by their supervisor. For most, this requires the input of total hours worked as well as for other options such as paid time off, corporate training or company events.

For Corporate Project Tracking, MIS and PeopleSoft, there are no controls to ensure time is charged to the correct project code aside from a limited choice of available project codes. Management has the opportunity but not the requirement to review the time coding of the employees they supervise as part of the weekly time reporting approval process.

*Noridian should institute controls over the input of time to the MIS Project Tracking System to assure that time is charged to correct project codes. While managers are required to approve employee time sheets on a weekly basis, other controls could include project cost budgeting, reporting and variance analysis.*

WorkForce data input screens provide menu choices that are customized by employee and based on their areas of responsibility and/or department. These menu choices are contained within the three tracking databases noted above. WorkForce is maintained by the Cost Allocation Unit of the Finance Department, and reminders are sent to employees who have not loaded their time by established deadlines. Output from the WorkForce time tracking system feeds two subsystems and for different purposes:

1. SmartStream Payroll – labor hours formatted for payroll calculation purposes is fed from WorkForce to the SmartStream Payroll application (SQL Server).
2. OutlookSoft - A separate feed of WorkForce extracts is sent to the SAP BPC (OutlookSoft SQL Server). This database is used for internal analysis and reporting purposes. A member of the Finance Department reconciles the interface from WorkForce to OutlookSoft by comparing record counts. Another member of the department reviews the data in OutlookSoft for reasonableness.

### **Statistical**

Other allocations are more manual in nature and are generally based on objective statistics of usage or causal measures deemed appropriate by management. Examples of such methods include the use of claim counts, premium dollars, salary dollars or system usage.

In 2008, there were approximately 43 different statistical allocation calculations performed each month, mainly in spreadsheets. While these calculations are performed within the cost allocations unit of the Finance Department, many of the key inputs used to perform the calculations are provided by other business units within the organization.

Noridian's statistical allocations are more manual in nature and are generally based on objective statistics of usage or causal measures deemed appropriate by management. Examples of such bases include the use of claim counts, premium dollars, salary dollars and system usage. The form and nature of these statistical allocation calculations vary considerably. However, a common characteristic is the manual or spreadsheet-based nature of the calculations. Additionally, these allocations require the manual keying of data from the spreadsheets into other databases that ultimately feed the ledger (Manpower by way of BOLTS, for Burroughs Online Transaction System).

*Noridian should develop a plan that would enhance the system capabilities and support of its cost allocation process; reduce significantly the amount of manual re-keying of data; reduce the usage of spreadsheets; promote the electronic collection and interface of data from underlying systems and sources; and improve related internal controls.*

### **Step 4: Allocations for Financial Reporting**

As part of the annual filings with the Department and with the NAIC, health insurers are required to report expenses by function, which include cost containment expenses, other claim adjustment

expenses, general administrative expenses and investment expenses. These functional allocations must be reported in total and also by major expense account category (e.g., rent, salary, travel, etc.). For NMIC, these allocations are reported in its Annual Statement in the *Underwriting and Investment Exhibit – Part 3 Analysis of Expenses*. The steps that NMIC uses to prepare this exhibit are summarized as follows:

- Accumulate all expenses for LOB codes in the range from 100 to 199 (these codes account for \$90,683,270 of Noridian’s total 2008 expenses of \$233,429,979).
- Add premium taxes (\$10,315,946 for 2008).
- Add Administrative Services Only (“ASO”) and Administrative Services Contract (“ASC”) fees (recorded as negative expense of \$28,029,727 for 2008).
- The resulting net total for 2008 is \$72,969,489, which reconciles to lines 20 and 21 in the Statement of Revenue and Expense; it excludes investment expenses captured in separate LOB codes and which are recorded as an offset to net investment income.
- NMIC applies a series of factors at the cost center level to allocate these costs to required classifications (cost containment, claim adjustment and general & administrative expense).
  - According to the Director of Finance, these factors were developed several years ago when the Finance cost accounting staff performed an analysis. A comprehensive update has not been performed since. There is no available documented support for current factors used.
  - This “rough allocation” will have to be refined starting in 2011 based on the requirements of the Patient Protection & Affordability Care Act. The preliminary work performed by the NAIC regarding Medical Loss Ratio calculation indicates new definitions for loss adjustment and cost containment expenses. Indications are that the reporting requirements will result in a significant added dimension to most existing allocation systems, a time-consuming and important change to implement under what is already a tight schedule.
- This entire process is performed within a series of excel spreadsheets.

While the new Patient Protection & Affordable Care Act (“PPACA”) requirements might be viewed as an extension of the requirements for the reporting of expenses within the Underwriting & Investment Exhibit Part 3, the importance and visibility of this information will be increased significantly, as certain operating expenses will impact the medical loss ratios as determined pursuant to the new PPACA and will ultimately impact potential member premium rebates. The existing separation of this process from the core cost allocation system will likely be deemed inadequate.

*Noridian should closely follow the development of new reporting requirements relative to MLR reporting. New expense studies may need to be performed, with the resulting allocation factors under additional scrutiny. Both system and reporting capabilities in this area will likely have to be expanded, an objective which may be more complex for Noridian to achieve due to its lack of adequate documentation, extent of one-off spreadsheet applications, key-man dependencies and legacy systems involved in its allocation processes.*

Within the Annual Statements filed with the Department and with the NAIC, health insurers are also required to report expenses by lines of business which include comprehensive (hospital & medical), Medicare supplement, and dental and vision, among others. The process for Noridian's allocation of expenses used in the preparation of this exhibit is as follows:

- Medicare supplement, FEP and Medicare Part D and Medicare Advantage expenses are separately identified by LOB through the expense allocation process.
- All other expenses are charged to Comprehensive or Stop Loss (part of Other Health) based on their relative share of gross premium.
- Premium taxes are allocated to Medicare supplement and to comprehensive and stop loss lines based on gross premiums.
- This allocation process is performed within excel spreadsheets.

The allocation process as described above is based on the expansion of the WorkForce system that was put into place by Noridian for 2010. Previously, time was recorded using a Unisys system entitled PAC and required the development and use of spreadsheets containing available task codes; there was no protection of cells and or dropdown menus to control users' choices. Templates were developed for each cost center and updated as needed. Users could add or delete rows, and there was no independent control over the validity of labor codes being entered. The IT department largely maintained this part of the process.

Under the new approach, PeopleSoft tables were developed that incorporated a master code list and resulting in a more controlled environment with restrictions on code use and availability and a greater degree of oversight from the Finance Department. WorkForce processing now includes a weekly cut-off with automated reminders for those whose time has not been loaded. This process also requires a certification for supervisory review and approval. If the supervisor misses the deadline for this electronic approval, there is a manual signoff form that must be completed and sent to the Cost Allocation Unit.

### **Testing by Invotex**

Invotex selected 2008 as the "base year" for the performance of certain analytical procedures and transaction testing. Due to the timing of the 2009 Target Financial Examination performed by the Department, and as a result of certain resulting organizational and policy changes instituted at Noridian during the past two years, 2008 was chosen because the activities, processes, procedures and controls examined would best represent the environment at Noridian during the overall 5-year examination period.

Invotex performed substantive testing to assess the accuracy of the allocation calculations described in the Noridian's Cost Allocation Methodology and Related Processes section of this report that begins on **page 28**.

Allocation calculations are performed monthly. Invotex randomly selected a sample of thirty-two cost center allocations for the month of November 2008 for testing, using the following selection parameters:

- Obtain testing coverage for each of the most widely used allocation methods based on dollar volume of expenses allocated by method in 2008.
- Focus on cost centers with material expense balances
- Include both service center and cost center allocations
- Deemphasize testing of cost centers that had recently been tested by Noridian's Internal Audit Department, relying instead on Internal Audit's reports and working papers

The testing procedures utilized by Invotex are summarized below:

- At the start of the examination, general ledger downloads of operating expenses for each year of the examination period were requested and reviewed; the downloads included cost center level expenses as allocated to LOB code.
- General ledger downloads were reconciled to audited financial statements and expense management reports.
- November 2008 balances for the selected sample of cost centers were extracted, and "effective allocation" percentage for each LOB code were calculated by dividing each cost center / LOB code expense balance by the cost center total expense balance for that month.
- November 2008 cost center allocation workpapers and other supporting documents for the sample selected were requested, along with a copy of the allocation master report for the month of November 2008.
- The allocation master percentages were compared to the supporting workpapers supplied by Noridian.
- The allocation workpapers were compared to the allocation method descriptions supplied by the company.
- The calculated "effective allocation" percentages were compared to the allocation master and supporting workpapers supplied by Noridian.
  - Transaction level detail supporting the November, 2008 expense balances for the sample chosen was requested.
  - Direct coding transactions were identified and separated from the balance of transactions subjected to the cost allocation system calculations.
  - The allocations for that portion of the transactions not subject to direct LOB coding were calculated by multiplying this balance by the Noridian Allocation Master percentages for each cost center in the sample.
  - The recalculated allocation percentages were added to the direct coded balances, summed, and then converted back to percentages.
  - This new set of allocation percentages was then compared to the "effective allocation" percentages calculated based on data from the Noridian general ledger.

Although some differences were expected due to management's ability to directly code transactions to one or more LOB codes and thus bypassing the established allocation methodology, no exceptions were identified through the foregoing test procedures.

## Documentation Issues

Invotex found that the documentation made available was insufficient to provide an adequate understanding of the environment, processes and controls in place at Noridian related to cost allocations. In numerous instances, Noridian's staff appeared to use reasonable calculations and procedures relating to cost allocations and documenting those results, but the work relied on their own institutional knowledge about past practices at the company inasmuch as there were no written policies and procedures that they could follow. Absent having such information in a documented form that has been approved by management, it is not possible to independently verify that the actual procedures are being performed as intended or are authorized. Because Noridian currently lacks a formal, overarching Cost Accounting Policy, it also is more difficult to assure that cost accounting practices used across the enterprise uniformly adhere to corporate intent.

*Cost allocation process documentation should be prepared, approved by management, maintained and used in practice to support the performance of cost allocation-related procedures. Such documentation should be identifiable to a process owner whose responsibility is to prepare and maintain the documentation with objectives, procedures and responsibilities clearly identified; reviewed and approved by appropriate levels of management; available for testing against actual practices by internal and external auditors; and made available upon request by third-party auditors (e.g., DCAA, DHHS, Centers for Medicare and Medicaid Services ("CMS"), the Department, and other auditors representing large groups).*

In the absence of sufficient documentation to facilitate an effective examination of the cost allocation process, it was therefore necessary for Invotex to supplement the documentation that was obtained from Noridian with walk-throughs of certain allocation processes and with supplemental inquiries of management. Invotex also made inquiries of Noridian's Finance and IT personnel to identify, document, and assess the key controls over those processes.

## Information Technology Control Issues

Noridian's cost allocation process involves many automated programs and systems, including the following:

- BOLTS - the interface system "Burroughs Online Tracking System"
- WorkForce - the time recording system
- MIS - an alternate time recording system for recording time for IT Projects and storing IT Projects
- PTS - Project Tracking System – holds all projects against which time can be recorded.
- Smartstream - brings together the percentages and does the allocation
- ManPower - calculates allocation percentages for Labor Costs
- PAC – an internally developed time coding and tracking system

The controls over the tables utilized in Noridian’s automated allocation-related systems do not include adequate change controls and testing around the process. Additionally, some of the programs are not well documented as they are very old and have not been changed for many years.

*It is recommended that change controls be implemented and appropriate testing performed to avoid incorrect modifications to the tables that could lead to erroneous allocations. Documentation should be developed that would allow analysis of the functionality and improvements and modifications made as needed.*

The “Time and Labor” allocation process has controls to ensure completeness of data entered, including reminders and emails sent, and requirements for daily and weekly verification of time being entered completely.

Within the “Form 33” allocation process there exists the potential for the entry and use of incomplete data, as the entry screen has some numbers that could be skipped and left as they were the previous month, or left blank. Checks are in place, but they are not adequate to ensure such errors would be caught. The “Semi-Automatic” process includes use of a similar entry screen to Form 33 and therefore could be incomplete and the error not be detected.

*It is recommended that a formal data entry control be put in place whereby the data that is entered is highlighted or the data from the previous month is deleted to allow the determination that all required current entries have been made and that all non-current data is not carried forward unintentionally.*

For labor allocations, some labor codes are loaded from PAC into ManPower. One control is a check for an invalid code number. However, there is no control in place to detect the use of an incorrect, yet valid, code number. Additionally, the capability to designate a task code as “inactive” deletes the history of that particular task. Users of the system have been instructed to avoid using this system capability, yet there is no control to ensure this does not occur.

*All labor codes should be validated as both valid and correct. The manual control to avoid the designation of a task to “inactive” status introduces the potential for important audit trails and data to be deleted. A control should be in place to prevent low the use of this function or to correct its functionality.*

# Allocation of Costs Between Self-Funded v. Fully Insured Business

## Current Allocation Process Description and Reported Results

NMIC functions as an administrator for various self-funded plans, providing fee-based claim processing services to the plan sponsors which bear the underwriting risk for payment of claims. NMIC's reported self-funded expenses compared with its total expenses during the examination period are summarized below.

<b>Noridian Mutual Insurance Company</b>						
<b>Examination Period Self-Funded Expense Comparison</b>						
	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Total NMIC Expenses	\$68,412,235	\$70,138,423	\$76,613,642	\$87,281,625	\$90,683,270	\$96,762,587
NMIC Self-funded Expenses	17,333,971	18,696,877	20,398,032	23,712,010	27,547,790	27,059,512
% of Total	25.3%	26.7%	26.6%	27.2%	30.4%	28.0%

Unless otherwise noted, the term "self-funded" as used herein includes ASO and ASC uninsured and partially insured health plans. ASO represents that portion of the self-funded business whereby NMIC pays member benefits using plan sponsor funds. ASC plans differ in that NMIC, as the administrator, pays claims from its own bank accounts and is subsequently reimbursed by the plan sponsor. The distinction between ASO and ASC is important from a risk perspective; for ASC business NMIC retains credit risk while it awaits reimbursement by groups for claims it paid on their behalf, whereas for ASO business NMIC avoids that credit risk.

For some self-funded plans, NMIC issues a stop-loss insurance policy in conjunction with the administrative services contract. The stop-loss policy covers claims incurred by the plan sponsor above a specified amount. Self-funded plans with such stop-loss insurance coverage are classified or referred to as "partially insured" plans.

Health insurers are required to report on the profitability of their self-funded blocks of business within the footnotes to their Annual Statements that are filed with state insurance regulators. NMIC's experience as reported in its 2008 and 2009 Annual Statements is summarized as follows:

<b>Year 2009</b>	<b>ASO</b>	<b>ASC Self-Funded</b>	<b>ASC Partially Funded</b>	<b>Total</b>
Gross Administrative Fees Accrued	\$ 3,010,427	\$ 1,960,012	\$ 22,721,905	\$ 27,692,344
Gross Medical Costs Incurred	-	41,185,429	397,581,386	438,766,815
Subtotal	3,010,427	43,145,441	420,303,291	466,459,159
Gross Administrative Expenses	3,487,877	2,212,853	21,359,053	27,059,783
Gross Medical Costs	-	41,185,429	397,581,386	438,766,815
	3,487,877	43,398,282	418,940,439	465,826,598
Net Gain/(loss)	\$ (477,450)	\$ (252,841)	\$ 1,362,852	\$ 632,561
<b>Year 2008</b>				
Gross Administrative Fees Accrued	\$ 2,306,455	\$ 990,806	\$ 24,732,466	\$ 28,029,727
Gross Medical Costs Incurred	-	28,153,649	380,409,158	408,562,807
Subtotal	2,306,455	29,144,455	405,141,624	436,592,534
Gross Administrative Expenses	3,184,328	2,055,046	27,767,560	33,006,934
Gross Medical Costs	-	28,153,649	380,409,158	408,562,807
Gross Expenses Incurred	3,184,328	30,208,695	408,176,718	441,569,741
Net Gain/(loss)	\$ (877,873)	\$ (1,064,240)	\$ (3,035,094)	\$ (4,977,207)

In its report on the 2004 financial examination of NMIC, the Department stated:

“[NMIC] does not allocate expenses to uninsured [i.e., self-funded] plans, reporting as ASC expenses in Note 18 to the Notes to the Financial Statements, an amount equal to gross administrative reimbursements received. This method produces a zero underwriting gain or loss. *NAIC Annual Statement Instructions* also require insurers to report the gain or loss from the uninsured portion of partially insured plans in Note 18 in a column separate from uninsured ASC plans. In its 2004 Annual Statement, [NMIC] combined partially insured business with fully insured business and reported the totals in a single column labeled ASC plans.”

The Department went on to recommend that NMIC “...adopt a method to allocate expenses for ASC plans...and treat ASC plans having stop loss coverage as two plans...in accordance with SSAP 47...”

For Annual Statement reporting prior to the 2007 calendar year, NMIC reported ASC self-funded claims with ASO claims as a single combined amount under the “ASC Plans” sub-caption of Note 18 of the Notes to the Annual Statement. In Annual Statements filed by NMIC for 2007 and subsequent calendar years, NMIC reported ASO and ASC self-funded and partially insured business separately.

For Annual Statement reporting prior to the 2007 calendar year, NMIC did not estimate or allocate expenses to the ASC/ASO plans; rather NMIC reported the administrative fees received for both ASC and ASO business in lieu of allocated expenses. This reporting method resulted in a breakeven underwriting result, i.e., there was a zero amount reported as underwriting gain/loss for those business segments.

Beginning in 2007, NMIC reported ASO and ASC self-funded and partially insured business activity separately. Expenses were allocated resulting in a 2007 net operating loss of \$1.06 million for the ASO portion of the business. However, for ASC business NMIC continued to report administrative fees received in lieu of allocated expenses, resulting in a zero operating gain/loss for ASC business in 2007.

For Annual Statement reporting for the 2008 and 2009 calendar years, NMIC reported separately its experience for ASO and ASC self-funded and partially insured business, including expenses allocated to each such business segment.

Invotex requested and reviewed available documentation on the self-funded allocation process used for 2008 and 2009. The approach employed by the NMIC is a three-tiered process:

#### Tier 1 – Direct Comprehensive Hospital and Medical Allocation

LOB 100 is used by NMIC to capture the majority of Comprehensive Hospital and Medical expenses. The allocation process begins with an analysis of LOB 100 cost center expenses in which the NMIC separates the cost centers into two groups, direct and indirect.

Direct expenses are primarily composed of Claims Administration, Actuarial and Member Services, Medical Management, Marketing and certain Information Services cost centers. These direct costs were allocated between fully insured and self-funded blocks based on the following statistics:

- Claims
- Member Months
- Eligible Member
- Contract Months
- Premium
- Groups
- Groups/Contracts

The Direct classification represents a pool of expenses that totaled \$29.4 million for 2008. The resulting allocation was \$13.3 million for self-funded (45%) and \$16.1 million for fully insured (55%).

#### Tier 2 – Indirect Comprehensive Hospital and Medical Allocation

Indirect expenses are allocated based on the relative split of direct expenses between self-funded and fully insured. In other words, all indirect expenses are allocated the same way. Indirect

expenses for 2008 totaled \$20.7 million, and were allocated between the self-funded and fully insured blocks using the 45%/55% split noted above.

Indirect expenses are primarily composed of Executive, Corporate, Human Resources, Finance and Audit/Compliance and other Corporate Services.

### Tier 3 – Other NMIC Insurance Expenses

The third tier involves the review of all other (non-LOB 100) NMIC expenses to determine the extent to which they include expenses pertaining to the self-funded blocks. Many of those LOB codes have been directly assigned to the fully insured block based on their nature (FEP, Medicare, NDPERS, etc.). NBPA costs (i.e., NMIC's ASO business) on the other hand, have been directly assigned to the self-funded block and classified as ASO.

There are several LOB codes in this group that are allocated between self-funded and fully insured plans based on the relative split of direct expenses. Most notably, this includes Blue Card Home and Pharmacy costs.

NMIC reported a loss of just under \$5 million on its self-funded business for 2008. For 2009, NMIC reported a gain of just over \$600,000. The primary reason for this difference was a manual top-level adjustment made by NMIC in 2009 in the manner of reporting stop-loss expenses. According to an October 5, 2009 memo from Noridian's Actuarial Department, NMIC determined that expenses pertaining to stop-loss coverage were inadvertently included in the self-funded footnote to its 2008 Annual Statement. Given that stop-loss revenue is not included within the definition of a self-funded plan, NMIC concluded the presentation was incorrect, given that revenues and expenses were not properly matched. The memo noted the following:

“In order to more accurately allocate expenses for self-funded groups, we should split expenses between the self-funded portion of these groups and the stop-loss coverage of these groups based on annual amounts of claims paid under stop-loss versus paid by the [self-funded] groups. This memo does not address how to allocate expenses between self-funded groups and fully insured in total. It only focuses on how to split the expense between stop-loss and [self-funded] for [self-funded groups]. Based on 2008 paid claims, this split would allocate 24.1% of expenses toward the stop-loss coverage of the self-funded groups.” [Emphasis in original]

The adjustment described above, as calculated based on 2009 stop-loss claim volumes, was 22.4%. The factor of 22.4% was applied to total LOB 100 expenses (direct + indirect), resulting in a shift of \$5.0 million of expenses from self-funded to fully insured plans.

Based on discussions with management, this “spreadsheet” approach was implemented for expediency. The allocation methodology used for direct expenses is, in many instances, inconsistent with the approach used for the entity-wide allocations. Additionally, the size of the indirect expense pool that is allocated based on the direct expense split is relatively large when compared with the allocation base. According to management in the Finance and Actuarial

divisions, this approach provides a reasonable estimate of the split of self-funded and fully insured expenses.

Beginning in 2010, NMIC reportedly has incorporated the allocation of ASO and ASC expenses into its cost allocation system, eliminating the inconsistencies that existed in prior years as noted above. However, these cost allocation system changes do not extend to the Stop Loss business; rather, management has reported to us that it intends to continue the use of the claims factor approach, as described above, to estimate Stop Loss expenses.

While Invotex did not perform detailed tests of the 2010 allocations, the validity of the claims factor approach is not self-evident. Implicit in such an approach is the assumption that all functional activities that support the self-funded business also support the administration of the Stop Loss business, and that these support services are consumed in proportion to the dollar amount of paid claims above/below the Stop Loss threshold. NMIC was unable to provide Invotex with an analysis to support such an assumption, but rather provided a memo stating why this method was chosen.

Stop Loss business can be considered a supplemental claims processing function, distinguished from purely self-insured plans by a relatively high dollar-level policy attachment point which then requires some administrative effort to track, aggregate and pay amounts that exceed the Stop Loss threshold. However, that effort would seem to be modest compared to what is required to adjudicate and administer the underlying claim, an exercise which must occur whether a Stop-Loss contract is in place or not. Thus, a much lower level of costs would seem to be allocable to Stop Loss business as compared to that which would be determined under a claims factor approach such as the one in place at NMIC.

Noridian's cost allocation methodology for the identification and reporting of self-funded expenses for years 2008 and 2009 was not consistent with the entity-level allocation process. Codes were not established to capture and distinguish costs between self-funded and fully insured business. This required estimating the corresponding amounts through a series of spreadsheet applications that were performed outside of the normal allocation system and methodology and which therefore may not have been subjected to the same degree of internal control. Furthermore, Noridian's cost allocation methodology for stop-loss business continues in 2010 to be inconsistent with the entity-level process because expenses are not coded to that line of business, but rather are estimated within this same spreadsheet.

*Noridian's identification and allocation of self-funded plan expenses should follow a consistent methodology, employing the same processes and subject to the same controls utilized in the entity-level cost allocation system. Stop-loss business should also be segregated within the financial reporting and cost allocation systems to eliminate the need for high-level, manual adjustments to estimate the allocation of expenses.*

## Analysis of Reported Results

Invotex prepared an analysis of the operating results for NMIC's self-funded and fully insured comprehensive insurance business segments, splitting out the Stop Loss business based on data provided by NMIC and consistent with the Stop Loss results reported in NMIC's 2009 Annual Statement footnotes. This analysis is as follows:

*Amounts in \$000 except PMPM data*

	Comprehensive 2009				Comprehensive 2008			
	SF	FI	StopLoss	Total	SF	FI	StopLoss	Total
Premium	\$ 466,459	\$ 675,555	\$ 63,024	\$ 1,205,038	\$ 436,593	\$ 628,905	\$ 57,151	\$ 1,122,649
Medical Costs	438,767	620,804	44,778	1,104,349	408,563	587,218	42,052	1,037,833
Expenses	27,060	58,724	5,419	91,203	27,548	52,853	4,759	85,160
Chg in Res	-	(2,592)	-	(2,592)	-	2,592	-	2,592
Net UW Gain/(Loss)	<u>\$ 633</u>	<u>\$ (1,381)</u>	<u>\$ 12,826</u>	<u>\$ 12,078</u>	<u>\$ 482</u>	<u>\$ (13,757)</u>	<u>\$ 10,340</u>	<u>\$ (2,935)</u>
<i>Med Cost %</i>	94.1%	91.9%	71.0%	91.6%	93.6%	93.4%	73.6%	92.4%
<i>Exp Prem %</i>	5.8%	8.7%	8.6%	7.6%	6.3%	8.4%	8.3%	7.6%
<i>Exp Med %</i>	6.2%	9.5%	12.1%	8.3%	6.7%	9.0%	11.3%	8.2%
<i>Est Member Months</i>	1,976,352	2,484,192	-	4,460,544	1,956,060	2,514,768	-	4,470,828
<i>Exp PMPM</i>	\$ 13.69	\$ 23.64		\$ 20.45	\$ 14.08	\$ 21.02		\$ 19.05
Actuarial/Membership	\$ 1,662	\$ 3,310	\$ 305	\$ 5,277	\$ 2,004	\$ 3,776	\$ 339	\$ 6,120
Claims Administration	8,045	11,384	1,048	20,477	10,505	12,133	1,091	23,728
Compliance/Audit/Ethics	335	545	50	930	360	519	47	925
Corporate Services	870	1,878	173	2,920	978	1,797	162	2,937
Development & Strategy	638	941	87	1,665	616	1,053	95	1,764
Executive	1,532	2,921	269	4,722	1,095	2,028	182	3,306
Finance	642	1,199	110	1,952	648	1,116	100	1,864
General Counsel/Fac	548	917	84	1,550	709	1,150	103	1,962
Human Resources	473	735	68	1,276	526	817	73	1,416
Information Services	6,697	9,347	861	16,904	2,957	4,439	399	7,795
Marketing	2,417	8,578	790	11,786	3,606	8,079	726	12,411
Medical Management	1,962	5,050	465	7,477	1,980	4,062	365	6,407
Provider Relations	1,240	2,965	273	4,479	1,565	3,258	293	5,116
Premium Tax	-	8,954	835	9,790	-	8,625	784	9,409
	<u>\$ 27,060</u>	<u>\$ 58,724</u>	<u>\$ 5,419</u>	<u>\$ 91,203</u>	<u>\$ 27,548</u>	<u>\$ 52,853</u>	<u>\$ 4,759</u>	<u>\$ 85,159</u>
<b><i>Exp Prem %</i></b>								
Actuarial/Membership	0.36%	0.49%	0.48%		0.46%	0.60%	0.59%	
Claims Administration	1.72%	1.69%	1.66%		2.41%	1.93%	1.91%	
Compliance/Audit/Ethics	0.07%	0.08%	0.08%		0.08%	0.08%	0.08%	
Corporate Services	0.19%	0.28%	0.27%		0.22%	0.29%	0.28%	
Development & Bus Strategy	0.14%	0.14%	0.14%		0.14%	0.17%	0.17%	
Executive	0.33%	0.43%	0.43%		0.25%	0.32%	0.32%	
Finance	0.14%	0.18%	0.18%		0.15%	0.18%	0.18%	
General Counsel/Facilities	0.12%	0.14%	0.13%		0.16%	0.18%	0.18%	
Human Resources	0.10%	0.11%	0.11%		0.12%	0.13%	0.13%	
Information Services	1.44%	1.38%	1.37%		0.68%	0.71%	0.70%	
Marketing	0.52%	1.27%	1.25%		0.83%	1.28%	1.27%	
Medical Management	0.42%	0.75%	0.74%		0.45%	0.65%	0.64%	
Provider Relations	0.27%	0.44%	0.43%		0.36%	0.52%	0.51%	
Premium Tax	0.00%	1.33%	1.33%		0.00%	1.37%	1.37%	
Total	<u>5.80%</u>	<u>8.69%</u>	<u>8.60%</u>		<u>6.31%</u>	<u>8.40%</u>	<u>8.33%</u>	

The 2008 amounts as shown above are based on NMIC's actual reported results, but adjusted on a pro-forma basis as the stop loss adjustment described in the preceding section had been applied in 2008. In other words, and with respect to the issue that gave rise to the adjustment in 2009, data for both years are shown in the above analysis on the same basis as was used by NMIC for reporting in 2009.

Based on the above analysis, the 2009 per-member-per-month cost associated with a self-funded contract is about \$10 lower when compared with costs for fully insured contracts. Premium taxes applicable to fully insured contracts but not to self-funded administrative contracts account for \$3.60 of the total difference. Another \$2.23 is attributable to Marketing costs, with the balance spread out among Medical Management, Actuarial, Claims and other functional areas. Management attributes these differences, generally, to the above-average contract size common to its self-funded clients.

When expenses are analyzed as a percentage of premiums, there is more consistency between the self-funded and fully insured segments. For example, Development and Business Strategy expenses are 0.14% of premium for both of those business segments for 2009, and with minor variation in 2008 (0.14% for self-funded v. 0.17% for fully insured).

A notable exception is marketing expenses which vary markedly for both years presented, with much more being allocated to the fully insured business as compared to the self-funded segment. The relative cost of marketing and servicing self-funded and fully insured policies was a focus of the examination. For example, the topic was discussed at most of the management interviews, for which Invotex received mixed messages. Most of the executives that we spoke to represented that there was no substantive difference in the level of efforts required to administer a self-funded versus a fully insured policy. However, several members of the Marketing department asserted that marketing and sales costs for self-funded policies or groups tend to be higher.

NMIC's former head of Marketing stated to Invotex that "...self-funded plans are a cost savings mechanism for the client with adequate size, and provides the client with more flexibility; self-funded plans by nature are unique, not standardized, so it takes more effort and time, not just to sell it but to service it. Rates vary by size of self-funded group, sliding scale usually as a % of claims, from 7.9% to 7.4%. Approx 90% of self-funded groups also purchase stop loss coverage." While that explanation appears plausible, as can be seen by the analysis above the converse is true, i.e., expenses as a percentage of premium are markedly higher for fully insured than for self-funded business.

Invotex shared this analysis with senior management within NMIC's Actuarial and Finance departments. Management was asked to explain the marketing expense allocations, and to comment on the reported per-member-per-month expense ratios. Management's response is as follows:

"It's widely understood that individual and small group [policies] are typically more expensive to administer than larger groups. Self-funded groups and large fully insured groups have many more members to spread the costs to. This is also reflected in the Health Care Reform legislation that mandates that individual and small group medical loss ratios be at least 80% leaving [no more than] 20% to cover administrative costs and margin compared to large group which is required to be at least 85% [no more than 15% for administrative costs and margin]. .... It becomes clear that the average size of the group for fully insured is a fraction of the size of the self-funded groups. If you divided the split of marketing for fully insured and self-funded business by the respective number of groups you will find that the cost per self-funded group is significantly higher than the cost per fully insured group."

The summary of the number of groups, stratified by size of group, referenced above is shown below.

**Summary of BCBSND fully insured and self-funded group business**

As of September 30, 2010

- Fully Insured Groups ..... 4,441
- Self-funded Groups ..... 692\*
- Total Groups ..... 5,133

*\* There are approximately 157 self-funded administrative service agreements covering a total of 692 groups including “single-employer” self-funded agreements covering multiple groups (or rolls) under one self-funded arrangement along with single or multiple agreements for association groups.*

**Breakdown of Health Groups by Enrolled Employee Count**

<u>Group Size</u>	<u>Number of Enrolled Employee Members</u>
1 to 2	1,513
3 to 5	1,297
6 to 10	795
11 to 15	385
16 to 20	241
21 to 25	177
26 to 49	317
50 to 100	185
100 +	183
Total	<u><u>5,093</u></u>

NMIC management also added the following comment. “BCBSND has a large number of groups (92.7 percent) in the 1 to 50 employee range. Acquisition and renewal costs for these smaller groups would naturally be higher on a PMPM basis as sales, service and renewal work can require much of the same documentation and time as needed for larger groups. Also, the larger the group the lower the commission paid.”

With respect to marketing expenses for self-funded plans, their relatively larger size lowers per unit costs, but the complexity of such plans tends to increase the amount of time and expense generated during the marketing effort. Noridian's management has asserted that, in general, expenses allocable to fully insured plans would be higher than for self-funded plans; that NMIC has no available means to measure an appropriate magnitude of the unit cost differential between such plans; and that marketing expenses for self-funded plans would be lower on a per-unit basis due to the size of such plans however the complexity of such plans tends to increase the amount of time and expense generated during the marketing effort. The end product of the allocation methodology "is what it is" with no means to independently verify that the end result of the allocation process is reasonable.

*InvoTex recommends that NMIC should enhance its financial reporting and cost allocation methodology and systems to capture the necessary information to report on the profitability of self-funded and fully insured plans at various group size levels. Stop-loss business should also be segregated within the financial reporting and cost allocation systems to eliminate the need for high-level manual adjustments to estimate the allocation of expenses. Management should perform an updated and comprehensive study of marketing expenses that considers the additional effort required to administer and sell self-funded policies and the size of group policies written and inforce.*

## **Review and Assessment of Internal Audit Work**

Noridian's Internal Audit Department conducted separate Cost Allocation Audits for 2008 and 2009 and issued their reports thereon dated February 9, 2009 and January 7, 2010, respectively. Copies of the supporting work papers were provided to Invotex in the form of a TeamMate project.

The audit objectives for the 2008 and 2009 Internal Audits included the following:

- Verify expenses were properly allocated to the lines of business (2008 & 2009)
- Confirm expenses were accurately recorded with the appropriate approvals (2008 & 2009)
- Review allocation methods for reasonableness (2009)

The 2008 Internal Audit included the testing of a sample of 15 cost centers for allocation percentage calculations and ultimate allocation to lines of business; no material findings were reported.

In the 2009 report on its audit of cost allocations, the Internal Audit department reported the following key findings:

“The process of determining, reviewing and approving cost allocation methods has not been formalized in documentation due to lack of personnel resources and/or prioritization. A formal cost allocation process should be defined and documented to assure consistent selection of appropriate allocation methods, periodic review and updates (as necessary) of methods, and appropriate approvals of methods in use. For all twelve cost centers sampled and reviewed Internal Audit noted outdated or incomplete cost center documentation. (The cost center documentation includes a description of the cost center activities, the allocation method selected for the cost center, and the review and approval dates of cost center management.) In addition, for these same twelve cost centers, there was insufficient evidence to support a timely review of allocation percentages by cost center management. The absence of a formal cost allocation process reduces the effectiveness of internal controls and may result in the use of cost allocation methods that do not accurately reflect the cost center activities.

The Internal Audit department recommends documenting a formal process for cost allocation methods. The process documentation should describe how allocation methods for each cost center are determined, and how often methods are reviewed and approved by Finance and cost center management. In addition, Finance and cost center management should update cost center documentation to accurately reflect cost center activities, allocation methods and their corresponding calculations, and the dates reviewed and approved by Finance and cost center management.

Based on the audit procedures performed, except for the finding described above, the allocation methods appeared to be reasonable; expenses were allocated to the appropriate lines of business, and expenses were accurately recorded with proper approvals.”

Although the scope of the 2009 and 2008 audits were similar as was the overall control environment over allocations in those years, the significant findings cited above from the 2009 report were not included in the report on the 2008 audit. It was represented to Invotex by a Noridian Internal Audit manager that such was likely the result of the Department's expanded examination activities during 2009 and the resulting heightened sensitivity within Noridian about expense policies and procedures.

Invotex discussed these findings with Noridian's Vice President of Ethics, Compliance and Internal Audit who posited that the findings evidence deficiencies in documentation and the lack of a formal process but that, nonetheless, no instances were identified by Internal Audit where those deficiencies resulted in an allocation error or misstatement.

The lack of complete and/or current documentation has been noted elsewhere by Invotex through responses to inquiries, walk-throughs, and review of documents made in the course of the targeted examination procedures. Noridian cites a lack of resources as the primary reason for such findings, and expects that such documentation issues will be remedied as part of the AFRMR compliance effort which is now under way. That said, Noridian is behind schedule in its AFRMR efforts and its Internal Audit resource issues appear to have become exacerbated at least in the short term due to employee turnover and internal transfers of staff. In response, Noridian has recently retained the services of its independent auditor, Eide Bailly LLP, to assist in the AFRMR effort.

While the determination of allocation method reasonableness was a stated objective for the 2009 Internal Audit, the resulting work papers and report make no mention as to whether such a determination was made or not. Internal Audit represented to Invotex that, in the absence of a definitive statement in the report, that Invotex should interpret the audit result as having found no evidence of deficiencies in the allocation methodologies. Given the complexity of the cost allocation system, that much of the underlying documentation appears to be inadequate, the materiality of the amounts involved as well as identified internal control weaknesses, it is apparent that Internal Audit could do more in this area.

*The determination of allocation method reasonableness was a stated objective for the 2009 Internal Audit, and the subsequent report stated no exceptions in that regard. Nonetheless, Internal Audit's work papers do not explicitly document the process or rationale used to evaluate reasonableness of the allocation methods used. Given the complexity of the cost allocation system, that much of the underlying documentation appears to be inadequate, the materiality of the amounts involved as well as identified internal control weaknesses, it is apparent that Internal Audit could do more in this area.*

The 2009 Internal Audit of cost allocations was the subject of discussion at Noridian's Audit Committee meetings. The minutes of the meeting of November 13, 2009 – which occurred prior to the issuance of Internal Audit's report on their 2009 cost allocation audit – include the following:

The [Audit] Committee discussed concerns around ... the expected finding in the Cost Allocations Audit... They directed Ms. Robertson, with support from Mr. Schwandt, to clearly convey to executives the [Audit] Committee holds them accountable for timely addressing weaknesses in internal controls. Further, there will be zero tolerance for lack of accountability, and executives will be required to report directly to the [Audit] Committee to explain unjustified circumstances which result in weaknesses not being addressed timely. Lastly, CAP [Corrective Action Plan] disclosure certifications signed without reasonable verification by the executive will be grounds for disciplinary action.”

The Audit Committee’s minutes of its January 21, 2010 meeting do not make explicit reference to Internal Audit’s work on cost allocations. However, reference is made to the Audit Committee’s review of the Audit Summary and the Aging and Closed CAP reports which were included as attachments to those minutes. The minutes also state that “the Aging and Closed [CAP] reports were discussed. Ms. Robertson noted a positive response from Executives regarding the Audit Committee’s directive, as noted in the November 13, 2009 minutes, to address internal control weaknesses more timely.” The Aging CAP report that was attached to the minutes includes a line item for the cost allocation audit noting the recommendation of “document formal process” with an estimated implementation date of October 31, 2010 and a medium risk level; the item was assigned to Finance for resolution.

Based on recent information provided to Invotex by Noridian’s Internal Audit Department, the status of this CAP item as reported by the Finance Department is as follows:

- The process narrative has been updated.
- A review of all cost centers with cost center management has been completed, updating cost center information, methods, and calculations.
- The cost allocation database has been redesigned to add linked tables to Excel spreadsheets that are updated monthly to capture changes in descriptions, management, and other factors.
- Standard descriptions have been established for each allocation method as well as a calculation description to ensure these are explained consistently.
- For cost center allocations that are modified from the initial basis, comments have been added explaining the additional modifications and how they were determined.
- The manual updates to the LOBs allocated have been removed as this information can change from month to month; instead management has been provided with their current LOB% information with the annual review.
- An allocation tracking spreadsheet has been added for all changes that occur to ensure that all the documentation is updated when cost centers are added, closed or when an allocation method is changed.

## **Assessment of Noridian’s AFRMR Compliance for Potential Reliance**

As part of its targeted examination procedures, Invotex inquired about the status of Noridian’s efforts to implement the requirements of the State’s Annual Financial Reporting Model Regulation (“AFRMR”), a successor to the former Model Audit Rule. North Dakota adopted the AFRMR effective April 1, 2010. The objective of Invotex’s inquiries was to determine if the governance and/or internal control aspects of the AFRMR had been implemented by Noridian and, if so, if there was information or processes that Invotex could look to or rely upon pertinent to Noridian’s cost allocations. As of the date of this report, Noridian has not achieved full compliance with the AFRMR.

Invotex, along with the full-scope financial examination team, met with Noridian’s Vice President of Ethics, Compliance and Internal Audit on several occasions to gain an understanding of the current AFRMR project status.

Noridian’s Internal Audit department issued a memorandum dated February 25, 2009, to all Noridian Executives, Managers and Directors outlining the most recently updated Risk Assessment for AFRMR compliance, describing the assessment methodology and identifying medium and high risk processes. Additionally, the document outlined next steps to be taken toward compliance, as follows:

- Development of process narratives
- Meetings with business units to identify key systems and applications
- Identification and documentation of risks and controls

Cost allocations was not initially identified as a significant process to be covered by NMIC’s AFRMR compliance process, but was added at a later date. Testing of controls was not addressed in the February 25, 2009 memorandum. Invotex did note that in the Annual Audit Schedule that was attached to the minutes of the March 26, 2010 meeting of Noridian’s Audit Committee that 57 areas had been identified by Internal Audit as part of the AFRMR implementation project; one of those areas is cost allocations.

Invotex requested and received a draft cost allocation process narrative during the examination; however it did not sufficiently describe the process, risks and controls relating to cost allocations.

A key milestone included in Internal Audit’s plans was to be the completion of process narratives by March 31, 2010. These narratives were to be developed by the business units and functional area management in consultation with the Internal Audit department staff. However, as of the date of this report process narratives for all identified processes have not been completed, and drafts of many narratives that have been submitted have been deemed inadequate by the Internal Audit department.

The inability of Internal Audit to fill these gaps in the short term has been exacerbated by recent transfers and terminations of some of the Internal Audit staff. Excluding the Vice President’s

role, Noridian's Internal Audit department currently has authority for 8 full-time positions; of those, only 5 are currently filled and that declined to 3 in August due to staff changes. More recently, Noridian has sought to supplement its internal resources allocated to the AFRMR implementation effort by engaging its independent auditor, Eide Bailly LLP, to assist in the process.

Noridian's efforts to comply with the AFRMR is not sufficiently advanced to result in information, process documentation, or testing of internal controls that would provide additional insights relative to Noridian's cost allocations. A full evaluation of Noridian's plans and efforts to implement and comply with the AFRMR's provisions is outside the scope of the Invotex examination. Nonetheless, cost allocations are an area of concern to the Department, and Noridian's independent auditors have identified expense allocation agreements as a key risk area. Therefore, it would appear prudent for Noridian to assure that cost allocations are covered by their AFRMR compliance efforts and in time to be able to file on a timely basis Management's Report on Internal Control over Financial Reporting as of December 31, 2010.

*Noridian should continue its efforts to resolve resource issues with the Internal Audit department and to take such other measures as are appropriate so as to assure timely compliance with the AFRMR. Although not required by the AFRMR itself, the Department's specific interest in Noridian's cost allocations would appear to warrant that the resulting process descriptions and testing results relative to cost allocations nonetheless be provided to the Department for its review.*

A more current status of the project as of the end of September 2010 as provided by Internal Audit is as follows, by Milestone number:

1. Define project objectives, roles and responsibilities;
2. Educate management, employees and the Board of Directors about the requirements and impact of the Regulation;
3. Conduct a gap assessment to determine areas of non-compliance;
4. Conduct a risk assessment to identify key financial accounts and their related processes and systems;
5. Establish a framework for compliance (e.g. establishing risk and control definitions, determining the appropriate level of documentation, defining standards for testing evidence, etc.);
6. Document processes and key controls within these processes;
7. Identify and assess entity and process risks.
8. Conduct testing to confirm controls are operating effectively;
9. Perform remediation of control deficiencies; and
10. Establish processes to attest to and report on internal controls, and maintain ongoing compliance.

Internal Audit reports that Milestones 1 through 6 have been completed; Milestone 7 is expected to be completed by mid-November; Milestone 8 will be determined based on the results of Milestone 7; Milestone 9 will be determined based on the results of Milestone 8; and Milestone 10 will be accomplished by June 2011.

## **Review and Assessment of 2009 External Audit Workpapers – Eide Bailly LLP Statutory Audit**

Noridian has retained the services of Eide Bailly LLP (“EB”) as its independent auditor. Among other services, EB performed the independent audit of NMIC’s statutory-basis financial statements as of and for the year-ended December 31, 2009 and issued their report thereon dated March 18, 2010. As an adjunct to their audit, EB also issued a Management Letter to NMIC’s Board of Directors.

EB’s Management Letter resulting from their audit of NMIC’s 2009 financial statements did not report or otherwise disclose significant difficulties in dealings with management, uncorrected misstatements within the financial statements, disagreements with management, or deficiencies in internal controls deemed to be material weaknesses. Cost allocation processes were reported therein as being among the most sensitive estimates affecting NMIC’s financial statements, and indicated that Noridian’s cost allocation processes are based on “agreed-upon best methods.”

EB’s Fraud Consideration Checklist identified complex and/or inconsistent expense allocation agreements as a significant fraud risk for Noridian. While a cost allocation agreement per se does not exist at Noridian, there is a more general intercompany agreement.

Based on documentation in EB’s working papers, a cost allocation walk-through was performed by EB on February 8, 2010 to test allocations to subsidiaries and affiliates through tracing of selected invoices through the allocation process, reperformance of allocation calculations and review of methods for reasonableness. That documentation indicated that each control procedure was deemed to be functioning as designed, and that no exceptions were noted.

However, the EB work papers did cite a Noridian internal audit report comment that “there is not a formal cost allocation process that defines and documents to assure consistent selection of appropriate allocation methods, periodic review and updates of methods, and appropriate approvals of methods in use.”

Invotex also reviewed EB’s work papers relating to their 2009 audit of NMIC regarding their testing of a sample of invoices, cost centers, LOBs and allocation methods; EB did not note any exceptions to their testing in those working papers.

## Review and Assessment of Deloitte Study

Deloitte Consulting LLP (“Deloitte”) was engaged by Noridian to conduct an “allocations review” of NAS. That engagement was completed with Deloitte presenting its findings to NMIC’s Board of Directors on April 23, 2010. InvoTex requested and reviewed a copy of Deloitte’s Powerpoint presentation to NMIC’s Board.

InvoTex met with Noridian’s CFO and with the Deloitte Principal who led the engagement, noting the following:

- Goals for the engagement included an assessment as to whether Noridian’s cost allocations comply with government standards, and also how Noridian’s cost allocation structure and processes compare with other industry participants and competitors.
- Noridian’s allocation approach is similar to that used by most competitors in the industry.
- NAS’s service center structure is more complex – and therefore perhaps more accurate – as compared to other similar sized and even larger competitors.
- Deloitte recommended that Noridian realign its classification of expenses between direct and indirect costs.
  - Such recommendation focuses on the classification of costs, and not on the overall magnitude of expenses.
  - Noridian traditionally has included more costs within indirect pools to be allocated as opposed to charging them as direct costs, relative to its peers. As an example: A supervisor oversees the activities of 6 individuals whose expenses are 100% allocable to one or more contracts as a direct expense. Most government contractors would classify the supervisor’s costs as direct; Noridian traditionally would have classified the cost as indirect. The implications are deeper than the title of classification; whether a cost is allocated on a direct basis or on some other allocation methodology can have a significant impact on the amount of work involved; whether or not the end result is most representative of the underlying economics; and can impact managerial decisions made based on the end data.
  - Impact to future contracting opportunities: Deloitte contends that Government agencies prefer to see higher direct costs and correspondingly lower indirect rates as it is easier for them to gauge the reasonability of direct costs.
  - Having a cost allocation structure that is more consistent with industry practice would enhance Noridian’s to benchmark itself against its peers, competitors and the industry.
  - Implementation of this Deloitte recommendation would help to address some of the audit comments from the DCAA; to eliminate key differences between NAS and its competitors in terms of expense structure; and would make NAS more competitive from a cost perspective as it seeks future government contracting opportunities.
- Some overall cost levels (regardless of classification) could be high. A separate engagement has been proposed to analyze costs in more detail to identify expense savings opportunities, but a decision to proceed with that has not yet been made by Noridian.
- Deloitte did not identify any fundamental allocation issues at Noridian.
- Deloitte’s presentation to Noridian’s Board summarized the nature of the industry in terms of market state, competition and the importance of government cost allocation and regulatory compliance; outlined keys to successful participation in the market, including the importance

of entity organization and the control of indirect costs; and provided some quantitative analysis of the level of variance of Noridian vs. industry indirect costs (overhead and G&A).

- The organizational structure of NAS has evolved from that of an insurance company to one that is more akin to a government service contractor, i.e., NAS now has a flatter organizational structure.

# Review and Assessment of DCAA and Other Large Group Audit Reports

There are three types of federal government audits that have recently focused on the expenses of NAS.

- DHHS Audits of Legacy Contracts
- DCCA Audits of Medicare Administrator Contracts (“MAC”)
- DCCA Audits of Disclosure Statements

Each is discussed below. Given that about 80% of NAS’ expenses are initially incurred on the books of NMIC, a primary objective of these governmental audits is to support the allocation of expenses from NMIC to NAS in compliance with federal Cost Accounting Standards.

InvoTex also requested and reviewed reports on audits conducted by other large groups, including the FEP and NDPERS plans. Those reports were focused entirely on claims accuracy and timeliness of payment with no findings or comments related to Noridian’s cost allocations.

## Background on Medicare Processing Provided by Noridian’s Management

Prior to 2003, Medicare contracts for Medicare Part A administration were assigned to each local Blue Cross plan without competitive bidding. Part B was retained by CMS to administer. These Pre-2003 contracts are described as “Legacy Contracts.”

Under the legacy contract system Medicare contractors were not permitted to make a profit, but they were not required to follow federal acquisition regulations or cost accounting standards. The intrinsic value to a BlueCross Blue Shield plan of having such a federal contract was the benefit of cost allocation; in other words, overhead could be spread across a larger subscriber base.

At Noridian, the growth of Medicare and Medicaid lines at NAS contributed to NMIC’s financial results to the extent that NAS absorbed a portion of NMIC’s overhead costs for which it was reimbursed by CMS to the extent of allowable expenses. The more costs allocated to NAS, the greater the benefit NAS could generate for NMIC and for Noridian as a whole.

After the Medicare Modernization Act of 2003, Medicare administration contracts became open to competitive bidding and Legacy Contracts were then replaced by MACs. Under this approach, contractors were permitted to earn an administrative profit and, if a contractor performed well by that measure, CMS would pay a reward fee. Therefore, NAS’ operation has experienced considerable changes over the years, and now has to become more profit-driven in order to win more Medicare contracts.

As a result of these changes, Noridian’s management asserts that NAS is under some pressure from state and federal government procurement agencies to demonstrate itself as a viable, stand-

alone and self-sustaining enterprise, with little need of parent-company support and, as a result, that expense allocations between NAS and NMIC are under considerable internal scrutiny.

Currently, about half of NAS' Medicare contracts are Legacy Contracts, and half are MACs. The latter subject NAS to the requirement to comply with government cost accounting standards ("CAS"). Disclosure Statements are required by CMS to describe in detail the cost allocation process used by the contractor and must also demonstrate compliance with federal CAS and Federal Acquisition Regulations ("FAR") Part 31.

**DHHS and DCAA Audits:** The following audits were performed by DHHS and DCAA of NAS during the examination period:

DHHS report dated November 30, 2007: This report covered administrative cost charges for 2004 – 2006 for Medicare Parts A & B. DHHS found administrative costs for the three-year period of \$255,826,979 to be reasonable and allocable in accordance with FAR and the Medicare contract provisions. (Noridian's Internal Audit department advised Invotex that a DHHS report covering 2007 – 2009 is expected to be released later in 2010.)

DCAA report dated May 21, 2009: This report covered the allocation of home office expenses for 2007 and found NMIC to be in noncompliance with the requirements of 48 C.F.R. 9904.403 because its Residual Pool expenses during 2007 included costs that could be allocated on the basis of a more beneficial or causal relationship. DCAA reported that almost 37% of a \$9 million residual cost pool should have been allocated based on either headcount or labor hours, rather than remain in the residual pool. Noridian initially responded that it interpreted the requirements differently than DCAA, but has since consented to comply with DCAA's recommendation. Noridian also responded that the cost impact of moving the subject cost centers from the residual pool to homogenous pools would result in additional costs due from the Government of approximately \$616,000.

The DCAA audit recommendation is consistent with changes recommended to NMIC by Deloitte. The changes impact the structure of the allocation in terms of how costs are classified as either direct expenses or as indirect expenses, with no net impact on total costs across the enterprise on a gross (pre-government reimbursement) basis. There could, however, be a significant impact on the level of costs allocated among contracts within an entity, and with the benefit of reimbursement by third parties, a net bottom-line impact.

DCAA reports dated August 14 and September 24, 2009: These reports commented on the adequacy and compliance of NMIC's revised disclosure statement dated January 1, 2008. DCAA found that the statement did not adequately describe NMIC's revised cost accounting practices, but that NMIC's practices nonetheless comply with applicable CAS and FAR Part 31. For example, DCAA found an error in the description of an allocation internal relationship, but the allocation process was nonetheless functioning properly. NMIC agreed to revise the disclosure statement.

DCAA reports dated September 25 and November 16, 2009: These reports covered NMIC's home office cost submission for 2006 and 2007 and found some adjustments relating to almost \$600,000 of costs for consulting, travel and other expenses in the residual pool that DCAA

questioned because of lack of documentation or authorization, or for being outside the contract period. NMIC responded that certain terms in contracts with some consultants were not updated on a timely basis, but that the costs are otherwise valid. CMS has yet to issue a final ruling.

InvoTex did not identify comments or findings in the DHHS or DCAA audit reports that would indicate fundamental flaws in NMIC's cost accounting methodology. The exceptions noted in the reports focus on individual items and appear to be primarily the result of inadequate documentation. The findings in these reports appear to be focused on compliance, but do not suggest that there are significant issues relative to Noridian's cost allocations that would be material from a financial perspective.

## **Review and Assessment of Sherlock Expense Evaluation Report**

NMIC participates in an annual study of its functional expenses relative to its peers. The *2009 Sherlock Expense Evaluation Report - Blue Cross Blue Shield Plans Edition* (“Sherlock Report”) produces statistics and analysis summarizing the performance of leading health plans. The 22 Blue Cross and Blue Shield Plans that participated in the 2009 study (based on 2008 business activity), comprised more than one-half of all Blue Cross Blue Shield Primary Licensees.

The Sherlock Report presents participant results relative to a peer group that includes many similar-sized Blue Cross and Blue Shield plans as well as other independent and provider-sponsored plans. Inotex requested and reviewed the survey results, and the underlying data and approach, in an effort to validate the reported expense ratios.

Excerpts from the 2008 Summary Memo to the Sherlock Report, issued October 28, 2009, include the following:

“[NMIC] administers health plans at low cost compared with its peers...regardless of whether it is measured on a reported basis, or adjusted for product mix...and regardless of whether costs are measured in dollars or as a percentage of premiums.”

As a result of the Department’s prior targeted examination of NMIC, the North Dakota Insurance Commissioner directed NMIC to “adopt and implement stricter standards in all matters of BCBS operations, human resources and financial management to ensure that the organization is managed for the good of its members.” In communications with the Department, NMIC has cited the Sherlock Report’s results, most notably the low administrative expense ratio reported for NMIC relative to its stated peers, suggesting that the NMIC is already functioning with a high degree of efficiency.

Inotex reviewed the summary memo for NMIC’s 2008 Administrative Expense Comparison. This study compared NMIC’s expenses with peer companies (as determined by the Sherlock Report) on a per-member-per-month basis and as a percentage of premiums (including premium equivalents for plans writing ASO and ASC plans). A summary of these results is shown in the following table.

**Sherlock Expense Evaluation Report Summary  
Noridian Mutual Insurance Company - 2008 Results**

<u>Per Member Month</u>	<u>"Blues" Plans</u>	<u>Independent / Provider Plans</u>	<u>Public Companies</u>
Noridian	16.29	16.29	16.29
Median	25.95	30.36	30.03
Difference	9.66	14.07	13.74
 <u>As % of Premium</u>			
Noridian	6.67%	6.67%	6.67%
Median	9.95%	8.29%	10.12%
Difference	3.28%	1.62%	3.45%

The Sherlock Report also re-weights study results for the peer population of each comparison group to match the NMIC product mix so as to eliminate the effect of inherent cost differences in providing the various health insurance product lines. This “mix-adjusted” survey result is reflected in the table below.

**Sherlock Expense Evaluation Report Summary  
Noridian Mutual Insurance Company - Mix-Adjusted 2008 Results**

<u>Per Member Month</u>	<u>"Blues" Plans</u>	<u>Independent / Provider Plans</u>
Noridian	16.12	16.12
Median	24.98	26.04
Difference	8.86	9.92

The mix-adjusted results above are not significantly different from the base study.

In an effort to validate the reported expense ratios, Invotex examined study materials and reconciled figures used in the study to the Annual Statement. Expenses reported in the Sherlock Report were approximately \$6.9 million lower than that reported with NMIC’s 2008 Annual Statement. Amounts specifically excluded include the following:

- Medicare Part D expenses of \$3.6 million are excluded because the Sherlock Report does not report on Medicare lines of business. The premium base and member-month calculations also exclude Medicare Part D.
- Expenses for Blue Card Host of \$1.7 million were excluded. This relates to members serviced by NMIC because they reside in the state of North Dakota but who are covered under a group contract underwritten by another Blue Cross Blue Shield plan. NMIC

assumes no insurance risk, and service fees are recorded within Other Income and Deductions. Membership and premiums pertaining to the Blue Card Host program are also excluded from the study.

- Approved Systems Enhancement costs of \$1.3 million have been excluded from the expense base used in the Sherlock Report. NMIC established an LOB code to segregate expenses relating to a multi-year effort to update its administrative system. Given that systems enhancements in the health insurance industry are a significant and ongoing effort, it is not clear why such costs would be excluded.
- Other less material exclusions include expenses pertaining to NMIC North Dakota Immunization program and Medicare Advantage costs.

NMIC chose to exclude from the reported expenses certain systems enhancement costs deemed to be one-time expenditures, not reflective of routine operating expense levels. With the possible exception of these systems enhancement costs, the membership, premium and expense data used in the Sherlock Report appears to be consistent with NMIC's Annual Statement. Had these expenses been included in the study, the 2008 per-member-per-month administrative expense rate as shown in the Sherlock Report would increase from \$16.28 to \$16.54, which would not significantly impact one's interpretation of the results.

NMIC's expense levels generally compare favorably to those of its peers as reported in the Sherlock Report. However, for certain functions supporting NMIC's ASO and ASC businesses – including the Sales and Marketing and Claims functions – NMIC's expenses appear to be higher within its peer group, in some cases well above the 75th percentile. This could indicate that NMIC is less efficient from a cost perspective than its peers in those functional areas, and/or that NMIC's method of allocating expenses to those areas is producing higher allocations than the methods that may be utilized by its peers.

Based on Invotex's review of the Sherlock Report, there are no matters presented therein that would provide insights as to the reasonableness of Noridian's cost allocation processes or results.

*As instructed by the researchers who authored the Sherlock Report, NMIC excluded from the reported expenses certain systems enhancement costs deemed to be one-time expenditures and not reflective of routine operating expense levels. With the exception of these system enhancement costs, the membership, premium and expense data used in the Sherlock Report appear to be consistent with NMIC's Annual Statement. Had these expenses been included in the study, the 2008 per-member-per-month administrative expense rate as shown in the Sherlock Report would increase from \$16.28 to \$16.54, which would not significantly impact one's interpretation of the results.*

## **Invotex's Assessment**

Based on the work performed, Invotex found that the overall approach used by Noridian to address cost allocations and the underlying processes, practices, and allocation bases to be reasonable in light of industry practices. Such is likely the result of years of trial and error combined with years of experience in addressing audits performed by DCCA, DHHS, and other larger groups, as well as benefiting from the collective experience of BCBSA.

That said, Invotex did find ample instances of inadequate documentation, at all levels, from the top-level understanding of the process to the more detailed supporting documentation of calculations. There are instances where management cannot provide an explanation as to why a particular allocation method is being used, noting simply that it has been used for some time. Control weaknesses exist in the form of key-man dependencies, use of out-of-date legacy systems, extensive need for manual rekeying of data, and more.

Noridian's efforts to address these matters show some promise, but are yet incomplete. The CAP relating to Internal Audits 2009 report on cost allocations is not yet closed, and the efforts to comply with the AFRMR and extend its benefits to the cost allocation function are still in process.