SOUTH CAROLINA GENERAL ASSEMBLY
Legislative Audit Council

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A REVIEW OF BUDGETING PRACTICES AND RECENT DEFICITS AT THE DEPARTMENT OF HEALTH AND HUMAN SERVICES

- From FY 07-08 through FY 10-11, the Department of Health and Human Services expenditures increased 26%, while Medicaid average monthly enrollees increased 18%.
- In FY 09-10 and FY 10-11, the department did not have a structured system of forecasting expenditures, revenues, or cash.
- To avoid a deficit in FY 09-10, DHHS made timing adjustments in the payment and receipt of $46.4 million in non-federal funds and $67.8 million in federal funds. These adjustments were not authorized by the appropriations act. In addition, the department made questionable use of $5.5 million in non-federal funds from a restricted account.
- During the FY 10-11 appropriation process, the department did not inform the General Assembly of a projected deficit. If the department had not received a $222.5 million funding supplement during FY 10-11, the state could have lost approximately $700 million in federal matching funds.
- DHHS did not have an adequate system for internal monitoring of its budgets in FY 09-10 and FY 10-11. In addition, the state's external monitoring system was hindered by insufficient data.
- In FY 09-10, the department awarded a rate increase to a managed care organization four months earlier than required by the contract. This early payment cost the state $2.3 million.
- State law does not adequately limit the activities of agency employees who resign to work for companies that do business with the state.

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Introduction and Background

In this chapter, we describe the objectives of our review as well as the clients and services at DHHS.

Review Objectives

The Department of Health and Human Services (DHHS) administers the state's Medicaid program. Medicaid is a government health insurance program for categories of persons without insurance who have limited incomes or a combination of limited incomes and assets.

Members of the General Assembly asked the Legislative Audit Council to examine budgeting issues and deficits at DHHS. Our objectives were to review the:

- Accuracy of budget forecasting by the department.
- Factors that led to the department's FY 10-11 deficit.
- Steps taken by the DHHS to address deficits when they were detected.
- Extent to which the department has provided accurate, timely, and complete information to the General Assembly.
- Methodology for setting rates for Medicaid providers.
- DHHS policies and state law regarding direct and indirect contractual relationships with former agency employees.

Scope and Methodology

The period of our review was generally from FY 09-10 through FY 10-11, with consideration of earlier or more recent periods when relevant. We obtained information from a variety of sources, including:

- DHHS revenue, expenditure, and client reports.
- DHHS contracts.
- Federal and state laws and regulations.
- Other states.
- Interviews with staff from DHHS, the General Assembly, Office of the Comptroller General, and the Budget and Control Board.

Overview of DHHS

DHHS serves the following categories of Medicaid clients who have limited incomes or a combination of limited incomes and assets:

- Children under the age of 19.
- Pregnant women.
- Adults responsible for the care of and living with children under the age of 18.
- Children and adults with total and permanent disabilities.
- Children and adults who are blind.
- The elderly, aged 65 and older, for services and premiums not paid for by Medicare.

The types of services provided to Medicaid clients include:

- Coordinated (Managed) Care.
- Hospital Services.
- Nursing Home Services.
- Pharmacy Services.
- Physician Services.
- Community Long Term Care.
- Subsidized Insurance Premiums.
- Dental Services.
- Clinic Services.
- Transportation.

Summary Statistics

In FY 10-11, total DHHS expenditures were $5.9 billion. Of this amount, the federal share was approximately $4.5 billion (77%) and the state share was approximately $1.4 billion (23%).

In the same year:

- 22% of South Carolinians statewide were covered by Medicaid.
- The portion of residents covered by Medicaid across the state ranged from 15% in Beaufort County to 42% in Dillon County.
- 43% of all children were covered by Medicaid.
- Half of all births statewide and 85% of births to teens were funded by Medicaid.
- 75% of all nursing home beds were funded by Medicaid.

Current Management Team

The current management team of the agency was constituted in early 2011.

DHHS Budget Deficits in FY 09-10 and FY 10-11

In this chapter, we address trends in DHHS expenditures versus the number of Medicaid clients from FY 07-08 through FY 10-11. We also address the factors that contributed to a deficit in FY 10-11, including unauthorized expenditure and revenue timing adjustments and the questionable use of restricted funds in FY 10-11. The final two areas we address are the effectiveness of communication regarding the budget and the process for making budget forecasts.

It is important to note that this chapter is an analysis of the department's budgeting process and is not an analysis of the cost effectiveness of specific programs. In certain instances, it is possible for a program that is cost effective to be over-budget. By contrast, it is also possible for a program that is not cost-effective to be under-budget.

We will address the operation of specific programs in a report entitled *A Review of Medicaid Managed Care Rates and Expenditures and Other Administrative Issues at DHHS,* to be released later in 2012.

Trend in DHHS Expenditures Versus the Number of Medicaid Clients

As shown on Table 2.1, during FY 07-08 through FY 10-11:

- Total expenditures increased 26% — from $4.7 billion to $5.9 billion.
- Average monthly Medicaid enrollees increased 18% — from 718,345 to 850,590.
- Average monthly Medicaid enrollees as a percent of South Carolina's population increased from 16.3% to 18.4%.
- Expenditures per average monthly Medicaid enrollee increased 6.5% — from $6,496 to $6,915.
- Expenditures per capita increased 20% — from $1,059 to $1,272.

Table 2.1: DHHS Expenditures and Medicaid Clients From FY 07-08 through FY 10-11

	FY 07-08	FY 08-09	FY 09-10	FY 10-11	4-Year % Change
Total Expenditures (federal and non-federal)	$4,666,230,016	$5,154,993,312	$5,293,834,408	$5,881,859,900	26.1%
Percentage Change From Prior Year	-1.0%	10.5%	2.7%	11.1%	
Average Monthly Medicaid Enrollees	718,345	761,058	807,102	850,590	18.4%
Percentage Change From Prior Year	-2.7%	5.9%	6.0%	5.4%	
South Carolina Population	4,404,914	4,479,800	4,561,242	4,625,364	5.0%
Percentage Change From Prior Year	1.9%	1.7%	1.8%	1.4%	
Average Monthly Enrollees as a % of Population	16.3%	17.0%	17.7%	18.4%	12.8%
Percentage Change From Prior Year	-4.4%	4.2%	4.2%	3.9%	
Total Expenditures Per Average Monthly Enrollee	$6,496	$6,773	$6,559	$6,915	6.5%
Percentage Change From Prior Year	1.8%	4.3%	-3.2%	5.4%	
Total Expenditures Per Capita	$1,059	$1,151	$1,161	$1,272	20.0%
Percentage Change From Prior Year	-2.8%	8.6%	0.9%	9.6%	

In Table 2.1, Medicaid enrollees are individuals who have been accepted into the program whether or not they received services during the year. The average monthly Medicaid enrollee statistic is the average number of enrollees per month for the year. And finally, total expenditures per capita are total expenditures divided by the South Carolina population.

Source: Governor's Executive Budgets and DHHS.

Questionable Expenditure and Revenue Timing Adjustments in FY 09-10

At the end of FY 09-10, DHHS projected that it would incur a deficit. To avoid this deficit, the department made unauthorized timing adjustments in the expenditure and receipt of $46.4 million in non-federal funds and $67.8 million in federal funds. In addition, the department made questionable use of $5.5 million in non-federal funds from a restricted account.

Factors Contributing to the FY 09-10 Deficit

When developing its budget for FY 09-10, the department forecast a 2.0% increase in Medicaid expenditures from the prior year. As shown in Table 2.1, however, expenditures of federal and non-federal funds increased 2.7% in FY 09-10. This increase was the net effect of a 6.0% increase in the average number of Medicaid enrollees and a 3.2% decrease in expenditures per average monthly enrollee.

During FY 09-10, the Budget and Control Board enacted two mid-year, state agency budget reductions. These reductions cost DHHS $70.5 million in non-federal funds.

DHHS officials reported that, in FY 09-10, the department was in transition from a fee-for-service reimbursement system to a managed care system, making budget forecasting more complex.

The department reported difficulty in monitoring its finances because it was transitioning to a new accounting system, managed by the Budget and Control Board. In April 2010, DHHS informed the Budget and Control Board's Division of State Information Technology of its concerns.

Also, in FY 09-10, the department did not have statutory authority to reduce reimbursement rates for health care providers to avert a potential deficit. This authority was restored by the General Assembly during FY 10-11.

Expenditure and Revenue Timing Adjustments and the Use of Restricted Funds in FY 09-10

To avoid an FY 09-10 deficit, the DHHS delayed payments to managed care organizations and medical home networks from FY 09-10 until FY 10-11. These delayed payments totaled $29.0 million in non-federal funds and $67.8 million in federal funds.

The department also accelerated the receipt of the following non-federal revenues from FY 10-11 to FY 09-10, totaling $17.4 million:

- $4.4 million in proceeds from a lawsuit settlement with a pharmaceutical company.
- $13.0 million in revenues from the state Department of Disabilities and Special Needs.

Each year, the General Assembly passes an appropriation bill that gives state agencies legal authorization to make expenditures and receive revenues for that year only. We found no authority for delaying FY 09-10 expenditures until FY 10-11 or spending FY 10-11 revenues in FY 09-10.

In the same year, the department also paid nursing home claims using $5.5 million in non-federal funds from a restricted account. This account is comprised of fines paid to the state by nursing homes. In §44-6-470 of the South Carolina Code of Laws, which describes the allowable use of these funds, we found no clear authorization for the actions of DHHS. The department repaid these funds to the restricted account during FY 10-11 and FY 11-12.

The combined effect of the revenue and expenditure timing adjustments and the use of restricted funds was an additional $51.9 million in non-federal funds and $67.8 million in federal funds available to the department for its use in FY 09-10.

DHHS Deficit in FY 10-11

During FY 10-11, the state Budget and Control Board determined that a DHHS deficit was unavoidable and authorized payment of the department's non-federal obligations totaling $222.5 million. This supplemental funding was authorized by §1-11-495 of the South Carolina Code of Laws. Without the supplement, the state could have lost an additional $700 million in federal matching funds.

Factors Contributing to the FY 10-11 Deficit

As shown on Table 2.1, total expenditures of non-federal and federal funds combined increased from $5.3 billion in FY 09-10 to $5.9 billion in FY 10-11. This increase was driven by two areas of significant change:

- The average number of Medicaid enrollees per month increased by 5.4%.
- Expenditures per average monthly Medicaid enrollee also increased by 5.4%.

The combined effect of more Medicaid enrollees and greater expenditures per enrollee produced an overall 11.1% increase in total expenditures, which was more than twice the 5% increase forecast by DHHS when preparing its budget.

DHHS began FY 10-11 with a $51.9 million deficit in non-federal revenues due to unauthorized expenditure and revenue timing adjustments and the questionable use of restricted funds in FY 09-10.

Several programs were operating at significant deficit levels in FY 10-11 until the Budget and Control Board made the supplemental allocation of $222.5 million in non-federal funds. For example, net "medical assistance payments" across 24 line items exceeded the original appropriation amount by $161.0 million. Within this net amount, the largest deficit line item was managed care, with payments exceeding the initial appropriation by $205.3 million. The largest surplus line item was Medicare pharmaceutical reimbursement to the federal government (known as "clawback"), with payments that were $17.7 million less than the initial appropriation.

Inadequate Communication Between DHHS and Central State Government

Between April 2010 and August 2010 there was inadequate communication between the Department of Health and Human Services and central state government agencies and officials concerning the magnitude of the financial problems confronting DHHS in FY 09-10 and problems anticipated to affect the agency in FY 10-11.

In August 2010, DHHS met with Ways and Means Committee and Senate Finance Committee staff and informed them of the financial problems that nearly resulted in the agency's running a deficit in FY 09-10.

As the agency moved from FY 09-10 into FY 10-11, DHHS became aware that it would incur a deficit in FY 10-11. In November 2010, the fifth month of the fiscal year, DHHS requested from the Budget and Control Board authorization to incur a deficit.

During our review, we requested e-mail correspondence between senior officials at the Department of Health and Human Services and the Office of State Budget of the Budget and Control Board, the Ways and Means Committee of the House of Representatives, the Senate Finance Committee, the Governor's Office, and the Comptroller General's office for the period from January 1, 2010, to November 3, 2010. We received e-mails dated from January 4, 2010, to November 3, 2010. We also reviewed e-mail documentation from August 1, 2008, to June 25, 2009, and from August 12, 2009, to June 29, 2010. We reviewed 740 e-mails which were dated from August 1, 2008, to November 3, 2010, as well as additional budget-related documents of current and former senior DHHS officials for FY 09-10 and FY 10-11.

Communication Requirements

State agencies submit their annual budget requests to the Office of State Budget (OSB) by October, where they are analyzed during November and December before the Governor submits an appropriations bill in January to the General Assembly. Budget requests are considered by subcommittees of the Ways and Means Committee which deliberate each agency's request. Subcommittee recommendations then move to the Ways and Means Committee and then the full House of Representatives. In the Senate, budget requests are deliberated by subcommittees of the Senate Finance Committee before consideration by the full Finance Committee and then by the full Senate. Opportunity for input exists throughout the process.

Proviso 89.130 in the FY 10-11 appropriations act requires that a state agency submit a plan to minimize or eliminate a projected deficit within 14 days of concluding that a deficit is "likely." If, after submitting a plan, the agency determines that the deficit cannot be eliminated, the agency is required to notify the Budget and Control Board within 30 days. State law does not require agencies that are projecting deficits to formally notify the General Assembly.

Inadequate Communication Regarding Potential FY 09-10 Deficit

Below is a review of communications between DHHS and the General Assembly, the Office of State Budget, and the Medical Care Advisory Committee on the agency's financial problems in FY 09-10.

Policy-makers depend on agencies for timely, accurate, and complete information about their financial circumstances in order to make reasonable spending decisions.

Communication With the General Assembly

We reviewed all e-mails and other documents for the period from April 1 through June 30, 2010 between senior DHHS officials and the General Assembly. We found no documentation of DHHS's having informed the General Assembly of a potential FY 09-10 deficit.

Communication With the Office of State Budget

In April 2010, the Office of State Budget completed a deficit monitoring review of DHHS for the third quarter of FY 09-10 and projected no deficit for the year. DHHS staff concurred, stating:

> At this time we are not going on record as anticipating an agency-wide deficit that cannot be handled by transferring funds. However, we expect it to be very tight, and do not anticipate any significant funds to carry forward.

DHHS did not indicate which funds might be transferred or the timeline involved. Two months later, in June 2010, DHHS officials implemented a strategy of postponing June payments into July, causing liabilities for the next fiscal year. At the same time, DHHS officials used revenues that were to be used in the next fiscal year to cover expenses in the current fiscal year. This strategy was designed to avoid a deficit in FY 09-10.

We found no documentation that the Office of State Budget inquired further into DHHS's proposed strategy of transferring funds or that it questioned the agency's eventual timeline adjustments regarding expenditures and revenues.

Other Opportunities for Public Notification of a Deficit

At no time from January through June 2010 was the Department of Health and Human Services or the Medicaid program a subject of discussion by the Budget and Control Board. We reviewed the minutes of the Board for the months of January, February, and June 2010. The Board did not meet during the months of March, April, and May 2010. We found nothing in the minutes reflecting that the Board ever discussed DHHS or the Medicaid Program during this period from January through June 2010.

Similarly, we reviewed the agendas and minutes for Medical Care Advisory Committee (MCAC) meetings from February 2009 to June 2010. Each state Medicaid agency is required by federal regulation, 42 CFR 431.121, to have such a committee. The Medical Care Advisory Committee advises the Department of Health and Human Services about health and medical care services. This committee is comprised of board certified physicians and other health professionals, members of consumer groups, and the director of the state public welfare or public health agency. No elected state officials, including members of the General Assembly, serve on this committee. At the February 2010 meeting a senior DHHS official reported to the Committee that the agency was running over budget and DHHS staff would continue to monitor the situation. In May 2010, this same senior official reported that the agency was continuing to operate over budget because of increasing Medicaid enrollment. There was no confirmation that the agency was facing

a year-end deficit or that the agency would be delaying payments or making other revenue adjustments to avoid a year-end deficit.

DHHS informed the Governor's Office in June 2010 of delayed payments to avoid a deficit in FY 09-10.

Inadequate Communication Leading Up to Request for Authorization of the FY 10-11 Deficit

State law mandated that if, after submission of a plan to minimize or eliminate the deficit, it was determined that the deficit could not be eliminated, the agency should notify the Budget and Control Board within 30 days of that determination to formally request authorization of the deficit.

Significant communication from DHHS regarding its FY 10-11 potential deficit did not begin until August 2010, the second month in the fiscal year. In an August 11, 2010, letter from the director of DHHS to the president *pro tempore* of the Senate, the director wrote that the FY 10-11 "budget shortfall" included liabilities from FY 09-10 that had been shifted into FY 10-11. At this time, DHHS did not project the amount of any projected shortfall. At the August 2010 meeting of the Medical Care Advisory Committee, a senior DHHS official referred to a "potential" budget shortfall resulting from differences between the agency's budget request and the appropriations act, increased enrollment, and FY 09-10 obligations paid in FY 10-11. No elected state officials, including members of the General Assembly, serve on this committee. In August 2010, DHHS officials initiated a series of meetings to discuss the budget outlook with the Governor's chief of staff, the staff of the House of Representatives Ways and Means Committee and Senate Finance Committee, and the Office of State Budget of the Budget and Control Board.

On October 20, 2010, the Office of State Budget sent e-mail correspondence to DHHS declaring that, based on its review of expenditures and briefings from the agency, "it is obvious that DHHS is projecting to run a deficit for the fiscal year."

On November 3, 2010, DHHS formally notified the Budget and Control Board that it requested authorization of a deficit for FY 10-11 and projected a $228 million deficit.

The timeline on page 12 highlights actions that occurred during the ten-month period leading to the formal request to the Budget and Control Board on November 3, 2010 that the Board recognize an unavoidable deficit for FY 10-11.

Conclusion

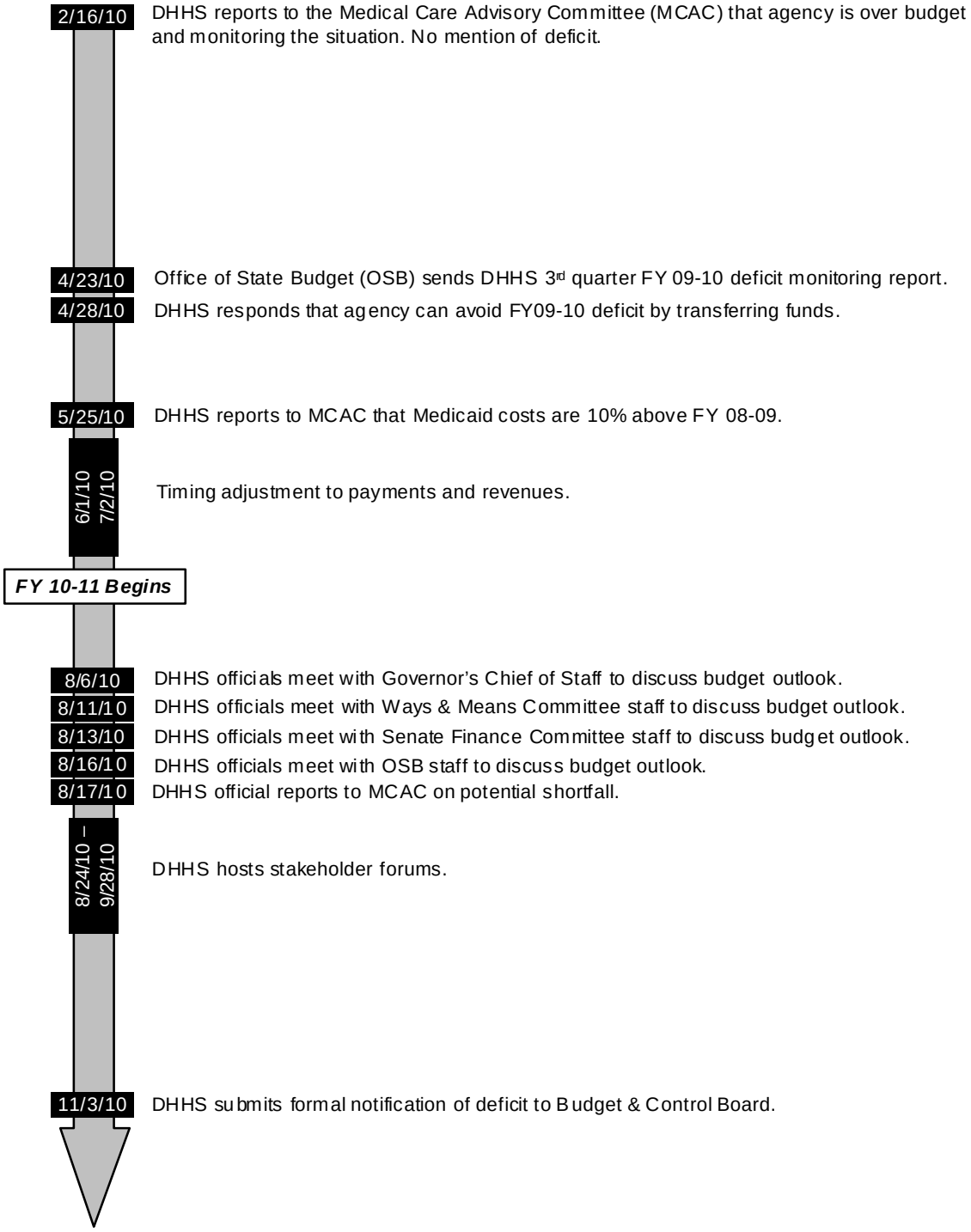
The appropriation process of the General Assembly would be more effective if it were accompanied by frequent and accurate communication from the state agencies receiving funds.

Recommendations

1. The Department of Health and Human Services should ensure and document its compliance with state law regarding communication of potential budget deficits.

2. The General Assembly should amend §1-11-495 of the South Carolina Code of Laws to require that state agencies immediately notify the Budget and Control Board and the General Assembly after projecting a deficit.

Chart 2.2: Deficit Timeline



Inaccurate Budget Forecasts by DHHS

DHHS deficits in FY 09-10 and FY 10-11 were accompanied by budgets that were not developed with sufficient controls to minimize inaccurate forecasting. During our review, however, the department made significant improvement in establishing a structured budget forecasting process.

State Law and Benefits of a Structured Budgeting Process

The annual budget of DHHS is part of the appropriations act passed by the General Assembly, based on detailed requests from the agencies.

Section 1-11-495 (B) of the South Carolina Code of Laws prohibits state agencies from exceeding the spending limits in the appropriations act unless formal approval is given by the Budget and Control Board. Therefore, during the appropriation process, it is important that each agency be precise, complete, and up-to-date when forecasting needed revenues, expenditures, and cash.

State agency budgets, when developed using a structured process, can be used to:

- Establish priorities among programs competing for limited resources.
- More precisely specify agency objectives regarding expenditures, revenues, and cash.
- Ensure cost control by agency program managers.
- Monitor and ensure compliance with spending limits in the state appropriations act enacted by the General Assembly.

See chapter three of this report for additional discussion of the use of budgets in monitoring and cost control.

Inaccurate DHHS Budget Forecasts

In its FY 09-10 budget plan, DHHS projected a 2.0% increase in agency expenditures, while the actual figure was 2.7%. In FY 10-11, the department projected a 5.0% increase in expenditures, while the actual figure was 11.1%.

As noted earlier, DHHS avoided a deficit in FY 09-10 by making timing adjustments in the payment and receipt of $46.4 million in non-federal funds and $67.8 million in federal funds. In the same year, the department also made questionable use of $5.5 million in non-federal funds from a restricted account.

In FY10-11, DHHS avoided a deficit with an infusion of $222.5 million in non-federal funds authorized by the state Budget and Control Board.

Controls to Minimize Inaccurate Forecasts

In developing its FY 09-10 and FY 10-11 budgets, DHHS did not use an adequately structured process for determining needed revenues.

The forecasting process during this period included obtaining estimates from DHHS program staff. Department officials report that the use of actuarial analysis as a tool for projecting the growth in the number of the department's Medicaid clients had not been fully implemented. Accurate forecasting is a key factor in developing DHHS's budget, because federal law requires that the states accept and serve all eligible Medicaid applicants.

Inaccurate forecasting, therefore, has the potential to result in significant deficits. The odds of a budget deficit are increased without a structured budget development process, with controls to minimize inaccurate forecasts.

During our review, DHHS reported that it was in the process of improving the structure of its budget forecast, including the increased use of actuarial analysis in its development.

Recommendation

3. The Department of Health and Human Services should ensure that it uses a structured process in developing annual budget forecasts of expenditures, revenues, and cash.

Avoiding Future DHHS Deficits

Avoiding future DHHS deficits will require improvements in:

- Communication with the General Assembly and the Budget and Control Board.
- Forecasting of the revenues needed to operate.
- Monitoring the department's budgets in relation to actual revenues, expenditures, and cash flows throughout each fiscal year (see p. 15).

Budget Monitoring

In FY 09-10 and FY 10-11, DHHS did not have an adequate process for periodic internal budget monitoring. In addition, the state's external monitoring system for detecting potential deficits was hindered by insufficient data.

During our review, DHHS reported its plans to implement a quarterly budget and quarterly variance reporting system for its expenditures. It had not implemented a similar system for revenues or cash flow.

State Law

Section 1-11-495(B) of the South Carolina Code of Laws states that:

> As far as practicable, all agencies, departments, and institutions of the State are directed to budget and allocate appropriations as a quarterly allocation, so as to provide for operation on uniform standards throughout the fiscal year and in order to avoid an operating deficit for the fiscal year.…
>
> The Comptroller General or the Office of State Budget shall make reports to the [Budget and Control] board as they consider advisable on an agency, department, or institution that is expending authorized appropriations at a rate which predicts or projects a general fund deficit for the agency, department, or institution.
>
> The [Budget and Control] board is directed to require the agency, department, or institution to file a quarterly allocations plan and is further authorized to restrict the rate of expenditures of the agency, department, or institution if the board determines that a deficit may occur. It is the responsibility of the agency, department, or institution to develop a plan, in consultation with the board, which eliminates or reduces a deficit.…

Internal Monitoring of DHHS Finances

In FY 09-10 and FY 10-11, DHHS did not develop quarterly budgets for expenditures, revenues, and cash flow. In a complex Medicaid environment, these factors can vary within a fiscal year due to changes in the economy, a new federal policy, transition to a new service delivery model, or normal seasonal variation.

The department also did not produce regularly scheduled budget variance reports. Used by many large corporate and government organizations, a budget variance report shows present budget versus actual revenues, expenditures, and cash for the relevant time period. A budget variance report

is useful for assessing the likelihood of a deficit early in the fiscal year, in time for expenditure and revenue adjustments to be made in a more effective manner.

The department also appeared to make excessive budget adjustments within individual programs. At the end of each fiscal year, actual expenditures for the majority of programs precisely equaled the adjusted budgets. While budget adjustments may sometimes be prudent during a fiscal year to account for changing circumstances, the extent of the adjustments by DHHS diminished their usefulness in managing the agency.

During our review, DHHS reported its plans to implement a quarterly budget variance report for its expenditures. It had not yet implemented budget variance reports for revenues or cash flows.

Recommendations

4. Each fiscal year, the Department of Health and Human Services should develop quarterly budgets for its expenditures, revenues, and cash flows.

5. Each quarter, the Department of Health and Human Services should develop variance reports comparing its budgeted amounts with actual amounts for expenditures, revenues, and cash flows.

External Budget Monitoring by Central State Agencies

In this section, we address the external monitoring of state agency budgets by the Budget and Control Board and the Office of the Comptroller General. We found that state law did not require sufficient information to be submitted to these oversight entities by state agencies, increasing the probability of an unexpected agency budget deficit.

Insufficient Information Required in Quarterly Monitoring Process

On a quarterly basis, the Office of State Budget compares year-to-date financial statistics with annual budgets.

State law does not require that all agencies submit, at the beginning of each fiscal year, annual budgets separated into quarterly budgets for expenditures, revenues, and cash flow. It also does not require quarterly budget variance reports to be developed by each state agency, comparing its budgeted revenues, expenditures, and cash to actual amounts. Without adequate quarterly budgets and budget variance reports, however, this oversight process will be diminished.

An effective quarterly budget would take into account projected seasonal differences in revenues, expenditures, and cash. It would not be developed by simply dividing an annual budget by four.

For variances in excess of a pre-determined threshold, the agency could be required to include a written narrative and any supplemental documentation needed for oversight agencies to assess the potential for a deficit or cash flow problem.

As noted above, during our review DHHS reported its plans to implement a quarterly budget variance system for monitoring its finances. This action, however, is being made on a voluntary basis by DHHS.

Recommendations

6. The General Assembly should amend §1-11-495 of the South Carolina Code of Laws to require that each state agency develop an annual budget at the beginning of each fiscal year that includes total expenditures, total revenues, and total cash flows divided into quarterly budgets. These budgets should be submitted to the General Assembly, Budget and Control Board, and the Office of Comptroller General.

7. The General Assembly should amend §1-11-495 of the South Carolina Code of Laws to require that each state agency develop a variance report each quarter, in which budgeted total expenditures, total revenues, and total cash flows are compared with actual amounts. These reports should be submitted to the General Assembly, Budget and Control Board, and the Office of Comptroller General.

8. The General Assembly should amend §1-11-495 of the South Carolina Code of Laws to require that each state agency include within its quarterly budget variance report an analysis of variances that exceed a pre-determined threshold. If a budget variance indicates a potential deficit, the agency should state in its report the actions that will be taken to avoid a deficit.

Early MCO Rate Increase and Inadequate Limits on the Activities of Former State Employees

In this chapter, we address a questionable rate change for a managed care organization (MCO) as well as the activities of state employees who resign to work for companies that do business with the state.

Early MCO Rate Increase Cost $2.3 Million

On June 1, 2010, DHHS increased the "capitation rate" four months early for a managed care organization that had recently acquired another managed care organization. As a result, the company was paid an extra $2.3 million.

DHHS pays managed care organizations to furnish care through a network of providers, such as hospitals, pharmacies, and others. Services authorized by the managed care organizations include care management, disease management, and care coordination. A capitation rate is a fixed payment remitted at regular intervals to a medical provider by an MCO for each enrolled member.

According to the MCO contracts dated April 1, 2010, with the exception of Supplemental Security Income (SSI), the capitation rates were required to remain in effect throughout the period identified on the rate schedule. For SSI, the contracts indicate that the "… capitation rate shall be subject to risk adjustment and recalculated on a six month basis." The department established an April/October schedule for these Supplemental Security Income rate adjustments.

During FY 09-10 and FY 10-11, DHHS implemented four SSI rate changes for all MCOs — October 2009, April 2010, October 2010, and April 2011. A special rate increase outside of this pattern was implemented for only one company in June 2010 (see Table 4.1).

According to a DHHS official, this rate increase was enacted because an MCO with lower-cost patients acquired an MCO with higher-cost patients. At the time of the acquisition, however, the MCO contract did not require rate changes outside the twice-a-year interval.

The two MCOs were combined two months after the April 1, 2010 semi-annual rate adjustment was in place. At that time, both MCOs had the same rate for all member groupings, with the exception of supplemental security income. The monthly SSI rate was increased by $49.10 for each member. Because of this early rate increase outside the semi-annual timing, DHHS paid an extra $2.3 million.

Table 4.1: Early SSI Rate Increase After MCO Acquisition

	Before Acquisition		After Acquisition
	Company 1	Company 2	Company 2
Effective Dates per Contract or Amendment	4/1/10	4/1/10	6/1/10
Supplemental Security Income Capitation Rate	$896.46	$783.88	$832.98

Source: DHHS.

Recommendation

9. The Department of Health and Human Services should adhere to the rate adjustment intervals established in its managed care organization contracts.

DHHS Executives Accepting Jobs From Company With DHHS Contract

DHHS reports that, in January 2011, its bureau chief in care management and medical support services and a deputy director of medical services resigned and accepted employment with a company that administered a private medical home network. Each of these employees had authority to approve payments to this company and other contractors.

State law does not consistently address potential conflicts of interest that might arise when employees leave state employment and work for private organizations that do business with the former employer.

Background

In a 2007 Legislative Audit Council review of the Department of Health and Environment Control, we noted the potential for conflict of interest because state law requires no waiting period before a former employee of a state regulatory agency may represent a client before that agency on matters in which the employee was not "directly and substantially" involved.

Those same concerns extend to non-regulatory agencies where former employees of agencies with service contracts resign and take employment with companies that do business with their former employers, particularly on matters with which the former employees had worked.

State Law

Section 8-13-755(2) of the South Carolina Code of Laws prohibits a public employee from accepting employment for a period of one year after terminating public employment if that employment:

> (a) is from a person who is regulated by the agency or department on which the former public official, former public member, or former public employee served or was employed; and (b) involves a matter in which the former public official, former public member, or former public employee directly and substantially participated during his public service or public employment.

According to an opinion issued by the State Ethics Commission on September 30, 1998

> A former public employee may not take employment with a contractor until one year has expired from the time that the contractor had procurement activity with the former employer in a manner in which he "directly and substantially" participated.

Federal and Other State Laws

Federal Law

Federal law, 18 U.S.C.§207, prohibits former federal employees from representing another person or entity by communicating or appearing before a federal department or agency concerning the same matter such as a contract or grant with which the former employee was involved while working for that agency or department. If that matter was pending under the employee's official responsibility during the employees' last year of federal employment, then the prohibition lasts two years. However, if the matter in question was one with which the former employee had been "personally and substantially" involved, then the prohibition against representation, communication, or appearances is permanent.

California

State employees or consultants who leave employment and subsequently work for an organization doing business with their former employer must wait one year before appearing or communicating with that former employer.

Conclusion

Because South Carolina law allows employees who oversee contracts or the work of contractors to resign and take employment with companies whose work they previously oversaw, the potential for conflict of interest exists and the appearance of impropriety, even when none exists, potentially undermines the integrity of the contract monitoring process. For example:

- Companies with an interest in acquiring or maintaining state contracts could be motivated to offer future employment to public officials with approval and contract management responsibilities.
- Public employees responsible for contract management or monitoring the performance of those companies with whom the state has a service contract might be less objective in their oversight responsibilities.

Recommendations

10. The General Assembly should amend §8-13-755 of the South Carolina Code of Laws to prohibit former state employees from being compensated to appear before or communicate with their former state agency employers for the purpose of influencing action for a period of at least one year after termination, regardless of the matters in which they participated while employed by the state.

11. The General Assembly should amend §8-13-755 of the South Carolina Code of Laws to establish a lifetime prohibition against former state employees being compensated to appear before or communicate with their former state agency employers for the purpose of influencing action on matters in which the employee was directly and substantially involved while a state employee.

Agency Comments

South Carolina Department of
Health & Human Services

Anthony E. Keck, Director
Nikki R. Haley, Governor

June 15, 2012

Mr. Perry K. Simpson, Director
Legislative Audit Council
1331 Elmwood Avenue, Suite 315
Columbia, South Carolina 29201

Mr. Simpson,

Thank you for the opportunity to respond to *A Review of Budgeting Practices and Recent Deficits at the Department of Health and Human Services*. The South Carolina Department of Health and Human Services (SCDHHS) has appreciated the chance to work with the Legislative Audit Council (LAC) to review – and more importantly - revise and reform the fiscal operations of the Medicaid agency. I am pleased with the progress we've made, as shown by the fact that the state's Medicaid program is on target to finish FY 2012 under budget. Clearly, the effort put into transforming our state's Medicaid program through smart policy – with the necessary budget forecasting, monitoring, and reporting required to support it – is paying financial dividends.

As the steward of substantial state and federal resources, SCDHHS is committed to effective and transparent fiscal policies and implementation. Responsible management of the sizable public resources dedicated to Medicaid allows the state to offer adequate and sustainable health coverage to those who rely on the program, while assuring budget stability and accountability to state leaders and taxpayers.

The breadth of fiscal management issues addressed in the Review, though seen through one agency's deficit experience, pertain to all of state government. Clearly, statewide consistency in projecting, revising, managing, and reporting of fiscal data could benefit all agencies, and assist legislators and legislative staff in understanding agencies' budgets.

This letter and the comments offered below serve to summarize SCDHHS' understanding of many of the LAC's recommendations, and to confirm the Department's commitment to leveraging this report to assist all state agencies in the complex task of budget projection, management, reporting, and the related communication to central state government.

Again, thank you for your work on this report.

Sincerely,

Anthony E. Keck
Director

AEK:jp
Attachment

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Comments on Recommendations Related to SCDHHS Fiscal Operations

SCDHHS would first point to the Review's core findings related to budget forecasting, monitoring, revising, and reporting – and the progress achieved at SCDHHS over the past year.

Recommendation #3 calls for "a structured process in developing annual budget forecasts of expenditures, revenues, and cash." SCDHHS has engineered a transformation of its internal budget reporting and management of expenditures, revenues, and cash. Actuarial data is now leveraged in initial and revised projections, with a formalized process of developing expenditures, revenues, and cash forecasts. Because predictability and stability of policy decisions affect the integrity of budget forecasting and management, SCDHHS supports recommendation #9 related to adherence to scheduled rate adjustments in agency contracts.

Recommendations #4 and #5 encourage the development and publishing of quarterly budgets and variance reports for expenditures, revenues, and cash flows. Since January of 2011, SCDHHS has developed models using monthly and quarterly reviews related to expenditures and revenue. The agency has implemented a formal executive-level quarterly management review of the entire budget, including the use of expenditure, revenue and cash flow variance reports. The quarterly analysis includes comparisons of monthly budget projections to actual spending as well as comparisons of current and prior year actual spending. The analysis includes an executive summary comparing actual collections and fund transfers. The executive summary includes tracking of budgeted revenues to cash collections and spending within each of the major revenue sources. We are in the final stages of implementing a cash flow model which will monitor weekly cash receipts and expenditures. The agency has deployed enhanced financial reporting to improve the internal review of spending at the program level including budget to actual reports, cost driver (volume, price and utilization impacts), and position inventory reporting. Additional financial policies and process improvements have been identified and will be implemented over the upcoming months.

In pursuit of these operational changes, a cultural change has also been implemented. SCDHHS staff now take direct responsibility for the Medical Assistance (provider payments) and administrative spending managed by their respective programmatic areas. Previously, not all program staff were responsible for understanding and managing their area's financial performance; this was left to finance staff. Objective fiscal performance criteria are now integrated into the Employee Performance Management System (EPMS). We are also in the final stages of reorganizing our department of finance, which will include a new comptroller in addition to a restructured budget planning office. This department will be managed by a newly hired chief financial officer.

Comments on Recommendations Related to Statewide Fiscal Operations

SCDHHS agrees that the recommendations in this Review should serve to launch statewide reforms to ensure fiscal accuracy and accountability in all state agencies. Management tools like actuarial projections and variance reports, though common in private industry, are largely absent in state government operations.

Recommendations #6, #7, and #8 call for changes in state law related to quarterly agency budget projections, the use of quarterly variance reports and thresholds to identify potential deficits and revenue shortfalls, and agency requirements to submit such information to central state government. A new enhanced budget process could ensure forecasts based on common agreed-upon planning assumptions and program-based goals and objectives. As noted above, SCDHHS is now utilizing quarterly variance reporting, a model that could be beneficial to other state agencies. In fact, the agency is now conducting periodic reviews of Medicaid and other contractual spending with all relevant state agencies.

Recommendations #1 and #2 relate to amending state law and ensuring agencies' immediate notification of the Budget and Control Board and General Assembly upon the projection of a deficit, and documentation of such communication. Past experience at SCDHHS would point to the value of such recommendations. The governor, legislators, stakeholders, and the public deserve the opportunity to understand public agencies' budgetary concerns, and participate in potential problem solving. Clear statute and policy guidance, strengthened by an environment supportive of openness and inclusivity, provide an environment essential to good government.

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