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Cost Principles for Expenses

DOCUMENT HISTORY LOG

STATUS ¹	DOCUMENT REVISION ²	EFFECTIVE DATE	DESCRIPTION ³
Baseline	1.0	November 15, 2005	Initial version Uniform Managed Care Manual, Chapter 6.1 Cost Principles
Revision	1.1	September 1, 2006	Chapter 6.1 revised to add provisions addressing: the applicability of the Federal Acquisitions Regulations (FAR); the ability of HHSC to recoup payments in the case of a federal disallowance and recoupment; the limitation on fees based on profitability; the allocation of indirect costs; a clarification on capital expenditures; and the limitation on rebates and profit sharing.
Revision	1.2	December 15, 2007	Chapter 6.1 is revised to remove references to “administrative” so that the section properly refers to “cost principles for expenses”
Revision	1.3	June 1, 2010	Chapter 6.1 is revised to add an “Applicability” section, include the CHIP Dental Program, and revise the definitions section. In addition, Section VI (2) “Advertising and Public Relations Costs,” is renamed “Marketing, Advertising, and Public Relations Costs,” renumbered as (27), and revised in its entirety.
Revision	2.0	March 1, 2012	Revision 2.0 applies to contracts issued as a result of HHSC RFP numbers X29-12-0002, X29-08-0001, X29-06-0293, X29-10-0020, and X29-12-0003. Chapter 6.1 is revised for the Uniform Managed Care Reprocurement. A number of changes are made, including refining the language with respect to reporting Affiliate costs, and the insertion of additional definitions.
Revision	2.1	April 15, 2012	Chapter 6.1 is revised to remove references to CHIP Perinatal as a program, to add Children’s Medicaid Dental Services, and to add exception language to Section VI. “Cost Categories,” #18 “Defense and Prosecution.”
Revision	2.2	July 20, 2013	Section I(B) is modified to add OMB A-122 and to clarify the language. Section I(C) is modified to clarify the language. Section I(D) is modified to clarify the language. Section I(D)(3) is modified to clarify that HHSC approval of use of Comparable Unaffiliated Sales exception does not exempt the approach from audit.



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STATUS ¹	DOCUMENT REVISION ²	EFFECTIVE DATE	DESCRIPTION ³
			<p>Section II is modified to reorder the definitions in alphabetical order and to update the definitions for “Allowable Expenses”, “Directly Associated Cost”, and “Experience Rebate.”</p> <p>Section VI is modified to clarify the language.</p> <p>Section VI(4) is modified to clarify that advisory council costs are generally unallowable and any exceptions would require advance review by HHSC and be subject to audit.</p> <p>Section VI(8) is modified to clarify that bad debts are unallowable.</p> <p>Section VI(14)(g)(3) is modified to clarify that abnormal or mass severance pay is generally unallowable and any exceptions would require advance review by HHSC and be subject to audit.</p> <p>Section VI(14)(h)(4) is modified to clarify that a substitute system would require advance review by HHSC and be subject to audit.</p> <p>Section VI(14)(h)(6) is modified to clarify that a substitute system would require advance review by HHSC and be subject to audit.</p> <p>Section VI(14)(i)(1) is modified to clarify language pertaining to “Employee Bonuses or Incentive Payments.”</p> <p>Section VI(28) is modified to clarify that costs of insurance are subject to audit.</p> <p>Section VI(34)(d) is modified to clarify that membership costs for civic and community social organizations are unallowable.</p> <p>Section VI(42) is modified to clarify that retrocession agreements are subject to audit.</p> <p>Section VI(47)(b) is modified to clarify that travel costs would require advance review by HHSC and be subject to audit.</p> <p>Section VII is modified to clarify the language.</p>
Revision	2.3	September 5, 2014	Revision 2.3 applies to contracts issued as a result of HHSC RFP numbers X29-06-0293, X29-08-0001, X29-10-0020, X29-12-0002, X29-12-0003, and X29-13-0042.



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			<p>Section I(B) is modified to delete the references to OMB Circular A-122 and replace it with 2 C.F.R. Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards</p> <p>Section I(D) is modified to delete the references to OMB Circular A-122 and replace it with 2 C.F.R. Part 200</p> <p>Section I(D)(5) is modified to change the “true-up” due date and to require written approval for any exceptions.</p> <p>Section VI(12) is modified to delete the references to OMB Circular A-122 and replace it with 2 C.F.R. Part 200</p> <p>Section VI(32)(d)(6) is modified to delete the references to OMB Circular A-122 and replace it with 2 C.F.R. Part 200</p>
Revision	2.4	October 15, 2014	<p>Revision 2.4 applies to contracts issued as a result of HHSC RFP numbers X29-06-0293, X29-08-0001, X29-10-0020, X29-12-0002, X29-12-0003, and X29-13-0042; and to Medicare-Medicaid Plans (MMPs) in the Dual Demonstration.</p> <p>“Applicability of Chapter 6.1” is modified to add the Medicare-Medicaid Dual Demonstration.</p>
Revision	2.5	November 1, 2016	<p>Revision 2.4 applies to contracts issued as a result of HHSC RFP numbers X29-08-0001, X29-10-0020, X29-12-0002, X29-12-0003, X29-13-0042, X29-13-0071, and X29-15-0001; and to Medicare-Medicaid Plans (MMPs) in the Dual Demonstration.</p> <p>“Applicability of Chapter 6.1” is modified to add the STAR Kids Program.</p> <p>Section I. A. "Introduction" is modified to add the STAR Kids Program.</p> <p>Section VIII. "Quality Improvement Costs" is added.</p>
Revision	2.6	May 15, 2018	<p>Section I.A. is modified to include text that was formerly in the Definitions section and to include clarification that certain types of expenses are subject to allowability rules.</p> <p>Section I.B. Clarifies the relevance of the FAR with respect to this contract.</p>



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			<p>Section I.D. Contains extensive clarification of the rules, definitions, exceptions and processes around Affiliate transactions and Affiliate cost reporting.</p> <p>Section II. Provides clarity around definitions, including: Allocable cost; Allowable expense; Fair Market Value.</p> <p>Section IV. Adds reference to Quality Improvement Costs and eliminates reference to fees based on profitability.</p> <p>Section V. Clarifies rules around allocation methodologies.</p> <p>Section VI. Updates reference to Affiliate cost reporting rules and updates definitions of Audit Services and Compensation. Clarifies the FAR citation for total compensation. Updates the support requirements for salaries and wages. Clarifies the allowability of employee incentive payments. Provides direction for reporting pre-implementation costs. Clarifies the allowability of the Health Insurance Providers Fee.</p>
<p>¹ Status should be represented as "Baseline" for initial issuances, "Revision" for changes to the Baseline version, and "Cancellation" for withdrawn versions.</p> <p>² Revisions should be numbered according to the version of the issuance and sequential numbering of the revision—e.g., "1.2" refers to the first version of the document and the second revision.</p> <p>³ Brief description of the changes to the document made in the revision.</p>			



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Applicability of Chapter 6.1

This chapter applies to Managed Care Organizations (MCOs) participating in the STAR, STAR+PLUS (including the Medicare-Medicaid Dual Demonstration), STAR Kids, STAR Health, CHIP, Children’s Medicaid Dental Services, or CHIP Dental Programs, and any other Texas Medicaid or CHIP capitated managed care contract that may reference these Principles. In this chapter, references to “CHIP” or the “CHIP Managed Care Program(s)” apply to the CHIP and CHIP Dental Programs. References to “Medicaid” or the “Medicaid Managed Care Program(s)” apply to the STAR, STAR+PLUS, STAR Kids, STAR Health, and Children’s Medicaid Dental Services Programs. The term “MCO” includes health maintenance organizations (HMOs), exclusive provider organizations (EPOs), insurers, Medicare-Medicaid Plans (MMPs), and any other entities licensed or approved by the Texas Department of Insurance.

The requirements in this chapter apply to all Programs, except where noted otherwise.

I. General

A. Introduction

This Chapter contains principles establishing the allowability or unallowability of certain medical expenses, administrative expenses, quality improvement expenses, reinsurance expenses, subcontract expenses, and other expenses relative to the STAR, STAR+PLUS, STAR Health, STAR Kids, CHIP, Children’s Medicaid Dental Services, and CHIP Dental Program Financial Statistical Reports (FSRs).

The allowability or unallowability of expenses impact the calculation of FSR-reported net income, and consequently may affect the experience rebate calculated in accordance with the Contract’s requirements. These principles apply to both direct and indirect costs. *A cost is allowable only to the extent of benefits received by HHSC under the Contract, and to the extent that the cost conforms to the policies, principles, and requirements of this Chapter.* A designation of “allowable” or “unallowable” does not generally govern whether the MCO can incur a cost or make a payment; allowability only reflects what is reportable on the FSR. To be allowable, expenses must conform to the requirements of this Chapter, which include being reasonable and allocable.

All costs reported on the FSR are subject to the cost allowability requirements under this Chapter. Until audits are completed on 334-day FSRs (and any corresponding adjustments are made to FSRs), amounts are subject to revision for appropriate reporting on the FSR, according to this Chapter. This may in turn impact calculations or payments for Experience Rebates on prior periods.

B. Relevance of the Federal Acquisition Regulations (FAR) and 2 C.F.R. Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards

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All costs, fees, assessments, Affiliate transactions, and Subcontracts are subject to the allowability tests and requirements as set forth in the FAR (48 C.F.R Part 31) and 2 C.F.R. Part 200, except where HHSC specifically allows an exception as documented in this Chapter or other Contract language. Any such exception must be specifically noted as an exception to FAR or 2 C.F.R. Part 200. If there is a conflict between the principles, regulations, or requirements of GAAP versus those of FAR or 2 C.F.R. Part 200, then FAR or 2 C.F.R. Part 200 prevails.

Regulatory language involving a CMS exemption of applicability of FAR or 2 C.F.R. Part 200 to Medicare will not overrule this Chapter.

For purposes of applying FAR to the terms of the MCO at risk contracts, such as Medicaid/CHIP capitation arrangements, the Contract will be classified only as "Other," whenever FAR distinguishes between Fixed Price, Cost Reimbursement, and "Other" contracts.

C. Federal disallowance/recoupment

If the federal government recoups money from the state for expenses or costs the federal government deems unallowable, the state then has the right to recoup payments made to the MCOs for these same expenses or costs, even if the state did not previously disallow those expenses. Going forward, the state would deem any similar expenses or costs unallowable. If the state retroactively recoups money from the MCOs due to a federal disallowance, the state will recoup the entire amount paid to the MCO for the federally disallowed expenses or costs, not just the federal portion.

D. Affiliate transactions and Affiliate cost reporting

Affiliate transactions and their treatment for purposes of the Contract generally fall into the categories and reporting requirements below:

(1) Medical claims - FMV reporting

Examples: In-patient and out-patient hospital services; Affiliate specialists or therapists.

(2) Medical outsourced services - FMV reporting (including the administrative portion)

Examples: vision services; behavior health services.

(3) Other medical services - FMV reporting

Examples: provider incentives; on-call physician charges.

If FMV for the above categories cannot be established, or if sufficient evidence of FMV cannot be provided, such transactions with Affiliates or Affiliate subcontractors must be reported at the Affiliate's actual cost incurred and will be subject to the same allowability tests as the MCO's costs for FSR reporting purposes.

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Pricing for medical outsourced services to an Affiliate must identify and differentiate between medical (including pharmacy) and administrative cost, and both medical and administrative costs must reflect pricing at FMV.

(4) Allocated administrative or Quality Improvement services - cost-based reporting

Examples: allocated services from parent or sister organizations.

Allocations of cost related to administrative functions or Quality Improvement from an Affiliate must be reported at the Affiliate's actual cost incurred. In addition, allocations of cost related to administrative functions from within the same legal entity, including allocations of cost from other programs, cost centers, departments, etc., within the legal entity must be reported at actual cost incurred.

(5) Outsourced administrative services or Quality Improvement services - cost-based reporting

Examples: Affiliate administrative service organizations.

Outsourced administrative or Quality Improvement functions must be similarly reported at cost unless all of the following conditions are present:

- a. MCO must represent less than 40% of Affiliate's total administrative services revenue,
- b. Affiliate's customer base for providing administrative services must include at least 4 other customers, and
- c. MCO's ultimate parent company must provide evidence that delivery of administrative services through a fee model rather than a cost model is the predominant business practice.

If the MCO wishes to request an exception to cost-based reporting, sufficient documentation in support of an exception to cost-based reporting must be submitted to HHSC's contract auditors during the audit cycle.

Administrative or Quality Improvement functions should not enrich the MCO or Affiliate organization. Administrative or Quality Improvement functions performed outside of Texas will be held to the same cost-reporting standards as those applicable to administrative or Quality Improvement functions performed by the MCO in Texas.

Other Reporting Considerations and Requirements**(1) FSR reporting requirements for Subcontractors, including Affiliates.**

Terms of the MCO Contract apply to all MCO Subcontracts. Consistent with the MCO's affirmative duty to not include its own unallowable costs in FSR reporting, the MCO is responsible for segregating any unallowable Affiliate costs for FSR reporting purposes. The "full cost" from an Affiliate does not generally include Affiliate profit labeled as an MCO cost. Costs incurred by Affiliate Subcontractors are subject to

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the same allowability tests as the MCO's costs, and therefore, may be disallowed for FSR reporting purposes.

HHSC's right to obtain and review financial and cost documents extends to Subcontractors, including the right to:

- (a) examine supporting documentation for cost build-up in Affiliate Subcontracts;
- (b) review a Subcontractor's income statement; and
- (c) segregate, within the income statement, certain revenue and cost categories by those attributable to the MCO Contract versus all other revenues and costs.

Any findings by HHSC or its auditors will not affect the Affiliate's books, records, or financial reporting; findings would only apply to the MCO's FSR reporting.

(2) Subcontract submission/notification: relevance to cost reporting allowability rules.

HHSC's review of a Subcontract or Affiliate agreement will not be construed as a determination that a cost or expense is allowable under state or federal laws, rules, or regulations, or the requirements of the MCO Contract, including this Chapter. Subcontracts are not exempt from audit and must conform to this Chapter.

Any approval of a Subcontract or Affiliate agreement by a regulatory agency other than HHSC does not release the MCO from the terms of the Contract. Thus, any approval of costs or transaction types by the Texas Department of Insurance (TDI) may be applied to the MCO's reporting to and compliance with TDI requirements, but does not provide exemption from this Chapter.

(3) Rules for FMV reporting.

Use of the FMV reporting does not require HHSC's prior written approval. However, the MCO must be prepared to provide to HHSC and the auditors the rationale they used to determine that the FMV treatment was appropriate. Supporting documentation may include names of specific unaffiliated entities that are sold to, prices to each, timeframe, and the comparability of the services being sold and priced. HHSC or its designee may require the MCO to submit information regarding sales classifications and price lists or contracts documenting pricing details.

Fair market value will apply to goods or services that meet the following criteria:

- (a) standardized, equivalent, measurable, or comparable;
- (b) bought and sold widely by multiple unrelated third-party sellers; or
- (c) have a readily available independent source for comparative market pricing data.

The burden is on the MCO to demonstrate to HHSC and the auditors that the Affiliate costs meet the criteria. It is not the responsibility of HHSC or its auditor to

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develop a market comparison analysis or to independently verify in any other way that the criteria are met.

Conducting studies (by third-party experts or otherwise) to determine an “industry range” of a percentage of premiums to assess for corporate overhead and services, or being “within market standards” or “based on prevailing market terms” for pricing, etc., may or may not provide valid grounds to support FMV treatment in the FSR. HHSC will consider such evidence on a case by case basis.

(4) Affiliate vs. unaffiliated third party Subcontracts.

MCOs may contract with Affiliates for various services in order to take advantage of economies of scale, potentially superior capabilities, and for other possible advantages or reasons. If the MCO procures services outside of unaffiliated, true arm’s-length situations, HHSC will examine the reported Subcontract costs and ensure allowability. If the MCO is unable to provide sufficient evidence of FMV for the set of services being provided by the Affiliate Subcontractor, HHSC retains the right to apply a minimum Medical Loss Ratio (MLR) requirement in determining the allowability of the administrative and profit component of the subcontract.

Amounts paid to Affiliate Subcontractors for goods and services rendered may not be allowable for FSR reporting purposes if they do not fall under an allowable category. MCO costs that are unallowable in terms of FSR reporting may not become an allowable deduction against reported FSR profitability by virtue of routing those costs through an Affiliate.

(5) Administrative expense assessment “true-up.”

Affiliate administrative services Subcontracts (e.g., a Subcontract with the MCO’s parent for headquarter support functions) must be limited to allowable costs incurred by the Affiliate. In many cases, these Subcontracts may be initially paid monthly, based on a pre-determined formula, such as a percentage of the MCO’s revenues, a fixed per-member-per-month amount, or a flat monthly amount. When such a formula-based approach is used by an Affiliate, the MCO must do a “true-up” of the actual allowable charges incurred by the Affiliate, versus the amounts initially recorded on the FSR by the formula. The “true-up” can be performed using a justifiable methodology based on verifiable data. The MCO must modify the FSR accordingly to represent only allowable costs actually incurred by the Affiliate. Such a “true-up” must be done, and its impact included into the FSR, by the 210-day FSR for each SFY. Any exception to this deadline requires written approval from HHSC.

II. Definitions

Advertising Costs means the costs of Advertising Media and corollary administrative costs, including the MCO’s cost of events oriented specifically and narrowly at outreach to potential CHIP or Medicaid Members in Texas.

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Advertising Media means magazines, newspapers, radio and television programs, billboards, bus and bench displays, banners, telephone books, outreach brochures, outreach exhibits, posters, stickers, decals, and internet advertisements. Advertising Media also includes promotional items and memorabilia, such as low-cost-per-item giveaways, souvenirs, and models, if these items are distributed to Program-eligible individuals or their family members. In order to qualify as Advertising Media, the item in question must be designed or intended to be read, heard, or seen by CHIP or Medicaid members or potential members in Texas.

Affiliate is defined in Attachment A, Uniform Terms and Conditions, Article 2, Definitions.

Allocable Cost means a cost that is allocable to the Contract if:

- (1) the goods or services involved are specifically chargeable or assignable to the Contract in accordance with relative benefits received, and
- (2) all activities which benefit from MCO's indirect cost will receive an appropriate allocation of indirect costs, and
- (3) any cost allocable to the Contract under the principles provided for in this document may not be charged to other contracts to overcome deficiencies, to avoid restrictions imposed by law or terms of such contracts, or for other reasons.

Estimates such as chargeback rates and GAAP accounting estimates are allowable costs, provided that they are supported by reasonable and auditable assumptions. Allocations of cost centers, general ledger accounts, or other batched invoice groups containing allowable costs comingled with unallowable costs are allowable, provided that they are substantiated by a documented analysis of costs attributable to the Contract and adequate auditable support of the analysis.

Allowable Expenses has the meaning assigned in Contract Attachment A, Uniform Terms and Conditions.

Direct Costs means those costs that can be identified specifically with and are readily assignable to the objectives of this Contract. A particular type of cost may benefit one or more other activities of MCO, but a portion of such cost may be readily assignable to the Contract and accordingly be treated as a direct cost. For example, a particular employee may perform services that benefit more than one activity; however, if the time spent on each of the activities can be identified and distributed to those activities through a personnel activity report, the amount of the employee's compensation distributed to each activity is a direct cost for that activity. Costs that can be specifically identified with and assigned to the activities under the Contract are generally categorized as direct costs. However, any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality where the accounting treatment for such costs is consistently applied to all activities of the MCO.

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Directly Associated Cost has the meaning assigned in 48 C.F.R. § 31.001.

Experience Rebate has the meaning assigned in the Contract's Attachment A, Uniform Terms and Conditions.

Fair Market Value (FMV), is the probable price of a transaction when the MCO and counterparty are:

- (1) not Affiliates,
- (2) knowledgeable of the relevant facts,
- (3) not under any obligation to buy or sell, and
- (4) entitled to all rights and benefits inherent in (or attributable to) the item included in the transaction.

Indirect Costs means those incurred for a common or joint purpose benefiting the Contract and one or more other activities of the MCO and are not readily assignable to the activities specifically benefited, without effort disproportionate to the results achieved. To facilitate equitable distribution of indirect expenses to the activities benefited, it may be necessary to establish a number of pools of indirect costs within the various departments of the MCO. Indirect cost pools should be distributed to activities benefited on bases that will produce an equitable result in consideration of relative benefits derived. For the purposes of distributing indirect cost pools to the Contract, the MCO is not allowed to include any indirect costs which do not benefit the objectives under the Contract.

Marketing Expenses means certain marketing-related expenses that are:

- (1) allowable for inclusion in the FSR, and
- (2) are to be recorded on the Marketing line in the Administrative Expenses tab of the FSR.

This is a more narrow definition than in the classic business sense. In this regard, Marketing Expenses are largely tied to outreach efforts, and do not include certain allowable related other costs, such as general public relations or advertising for recruitment of personnel. For more specific details, see "Marketing, Advertising, and Public Relations Costs" under Section VI, "Cost Categories."

Other Marketing Costs means any marketing costs that do not fall under the categories of Advertising Costs or Public Relations Costs.

Pre-implementation Costs means those costs incurred by the MCO on or after the Effective Date of the Contract but prior to the Operational Start Date of the Contract. Pre-implementation expenses are an allowable expense to Rate Period 1, subject to the limitations contained in the Contract's Attachment A, Uniform Terms and Conditions, Article 10.

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Public Relations Costs means the MCO's costs of community relations and those activities dedicated to maintaining the image of the MCO, or maintaining or promoting understanding and favorable relations with the community, public at large, or any segment of the public. This includes MCO news releases and MCO press releases.

Quality Improvement Cost has the meaning as described in 45 C.F.R. §§ 158.150 and 151.

Reasonable Cost means a cost that, in its nature and amount, does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. In determining reasonableness of a given cost, consideration must be given to:

- (1) whether the cost is of a type generally recognized as ordinary and necessary for the operation of the MCO or the performance of the services required under the Contract;
- (2) the restraints or requirements imposed by such factors as: sound business practices; arm's length bargaining; federal, state, and other laws and regulations; and, terms and conditions of the Contract;
- (3) market prices for comparable goods or services;
- (4) whether the individuals concerned acted with prudence in the circumstances considering their responsibilities to the MCO, its employees, the public at large, and the State of Texas; and
- (5) significant deviations from the established practices of the industry which may unjustifiably increase the cost incurred by the MCO to provide the services required under the Contract.

To be allowable, "reasonable" costs still must meet this Chapter's requirements, especially with respect to Affiliate transactions.

III. Applicable Credits

Applicable credits refer to those receipts or reduction of expenditure-type transactions that offset or reduce expense items allocable to the Contract as direct or indirect costs.

Examples of these transactions are: purchase discounts; rebates or allowances; recoveries or indemnities on losses; insurance refunds or rebates; and adjustments of overpayments or erroneous charges.

To the extent that these credits accruing to or received by the MCO relate to allowable costs, they must be credited to the Contract either as a cost reduction or an increase in revenues, as appropriate.

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The total administrative and Quality Improvement Costs of the Contract are comprised of the allowable direct costs of the program, plus its allocable portion of allowable indirect costs, less applicable credits.

There is no universal rule for classifying certain costs as either direct or indirect under every accounting system. A cost may be direct with respect to some specific service or function of the MCO but indirect with respect to the objectives under the Contract. Therefore, it is essential that each item of cost be treated consistently in like circumstances either as a direct or an indirect cost.

V. Allocation of Indirect Costs

Unless specifically allowed by HHSC, indirect costs that are assessed or allocated by a parent company or Affiliate to the relevant operating subsidiary are only allowable to the extent that:

- (1) the costs clearly represent specifically identified operating services provided for the operating subsidiary; and
- (2) the services directly benefit HHSC or its Medicaid or CHIP Members.

These specifically identified and directly beneficial services include core operating functions (e.g., centralized accounting, billing, IT), but do not include or allow items such as:

- (1) vague management allocations where there is no clear and direct identifiable benefit to the contract,
- (2) fees that are assessed in addition to total (direct and indirect) costs, or
- (3) overhead expenditure levels deemed clearly unreasonable (e.g., travel by private jet).

During any audit verification or prospective contract review, expenditures must be broken out separately by function and meet the test of reasonability, and other requirements described in this Chapter.

The MCO must develop an allocation methodology. The allocation methodology is subject to HHSC audit, and the MCO must be able to explain the methodology to HHSC's auditors.

See also "Administrative expense assessment 'true-up'" and other portions of Section I(D).

VI. Cost Categories

1. Accounting. The cost of establishing and maintaining accounting and other information systems is allowable.

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2. Add-on Fees. Amounts paid to an Affiliate that are in excess of actual costs incurred by the Affiliate, or that do not represent a pass-through of the actual costs of the Affiliate, are unallowable for cost-reporting on the FSR. This includes profit, margin, or mark-ups added to, or included in, Affiliate costs. Certain exceptions may apply; see Section I(D), "Affiliate transactions and Affiliate cost reporting."
3. Administrative Assessments. Certain parent company cost assessments for various administrative services provided to the MCO are allowable. However, any administrative services fees paid to, or assessed by, a parent or other Affiliate, which are unsupported in terms of actual documented specific allowable costs incurred by the Affiliate, are unallowable for cost-reporting on the FSR.
4. Advisory Councils. Costs incurred by advisory councils or committees are generally unallowable; any exceptions would require advance review by HHSC and would be subject to audit.
5. Alcoholic Beverages. Costs of alcoholic beverages are unallowable.
6. Audit Services. The costs of audits are allowable.
7. Automatic Electronic Data Processing. The cost of data processing services is allowable.
8. Bad Debts. Any losses arising from uncollectible accounts and other claims, and related costs, are unallowable.
9. Bonding Costs. Costs of bonding employees and officials are allowable to the extent that the bonding is in accordance with sound business practice.
10. Bond issuance cost amortization. Amortization of the costs involved in issuing bonds is unallowable. Similarly, bond discounts and other costs of financing are also unallowable.
11. Budgeting. Costs incurred for the development, preparation, presentation, and execution of budgets are allowable.
12. Capital expenditures. Expenditures for equipment or buildings, or repairs that materially increase the value or useful life of buildings or equipment, should be capitalized, and are unallowable, in terms of being totally expensed when initially incurred. Depreciation of these capital expenditures, and maintenance expenses, in accordance with Generally Accepted Accounting Principles (GAAP), 2 C.F.R. Part 200, or the Federal Acquisition Regulations (FAR), are allowable.
13. Communications. Costs of telephone, mail, messenger, and similar communication services are allowable.
14. Compensation for Personnel Services.
 - a. General. Compensation for personnel services includes all remuneration, paid currently or accrued, for services rendered during the period of performance



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under the Contract, including wages, salaries, performance incentives, and fringe benefits. The costs of compensation are allowable to the extent they satisfy the specific requirements of this Chapter, and the total compensation for individual employees:

1. Is reasonable for the services rendered and conforms to the established policy of the MCO consistently applied to all of its activities;
 2. Follows an appointment made in accordance with the MCO's policies and meets merit system or other requirements required by Federal law, where applicable;
 3. Is determined and supported as provided in Section VI(14)(h); and
 4. Does not exceed the total compensation (or a proportional amount thereof) set by statute (41 U.S.C. § 4304(a)(16)) and implemented at 48 C.F.R. §31.205-6(p).
- b. Reasonableness. Compensation for employees engaged in work on the Contract will be considered reasonable to the extent that it is consistent with that paid for similar work in other activities of the MCO. In cases where the kinds of employees required for the Contract are not found in the other activities of the MCO, compensation will be considered reasonable to the extent that it is comparable to that paid for similar work in the labor market in which the MCO competes for the kind of employees involved. Compensation surveys providing data representative of the labor market involved will be an acceptable basis for evaluating reasonableness.
- c. Unallowable Costs. Costs that are unallowable under other Sections of this Chapter will not be allowable under this Section solely on the basis that they constitute personnel compensation.
- d. Fringe benefits.
1. Fringe benefits are allowances and services provided by employers to their employees as compensation in addition to regular salaries and wages. Fringe benefits include the costs of leave, employee insurance, pensions, and unemployment benefit plans. Except as provided elsewhere in these principles, the costs of fringe benefits are allowable to the extent that the benefits are reasonable and are required by law, the MCO-employee agreement, or an established policy of the MCO.
 2. The cost of fringe benefits in the form of regular compensation paid to employees during periods of authorized absences from the job, such as for annual leave, sick leave, holidays, court leave, military leave, and other similar benefits, are allowable if: (a) they are provided under established written leave policies; (b) the costs are equitably allocated to all of the related activities of the MCO; and (c) the accrual basis of accounting utilized for costing each type of leave is consistently followed by the MCO.
 3. The accrual basis may be used only for those types of leave for which a liability as defined by Generally Accepted Accounting Principles (GAAP) exists when the leave is earned. When the MCO uses the accrual basis of

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- accounting in accordance with GAAP and complies with the other provisions of this Article, leave costs are allowable.
4. The cost of fringe benefits in the form of employer contributions or expenses for social security; employee life, health, unemployment, and worker's compensation insurance (except as indicated in Section VI(28), "Insurance and Indemnification"); pension plan costs (see Section VI(14)(e)); and other similar benefits are allowable, provided these benefits are granted under established written policies. These benefits, whether treated as indirect costs or as direct costs, must be allocated to the Contract and all other activities of the MCO in a manner consistent with the pattern of benefits attributable to the individuals or group(s) of employees whose salaries and wages are chargeable to the Contract.
- e. Pension Plan Costs. Pension plan costs may be computed using an acceptable actuarial cost method recognized by GAAP in accordance with established written policies of the MCO.
1. Pension costs calculated using an actuarial cost-based method are allowable for a given fiscal year if they are funded for that year within six months after the end of that year. Costs funded after the six-month period (or a later period agreed to by HHSC) are allowable in the year funded.
 2. Amounts funded by the MCO in excess of the actuarially determined amount for a fiscal year may be used as the MCO's contribution in future periods.
 3. The Contract must receive an equitable share of any previously allowed pension costs (including earnings thereon) which revert or inure to the MCO in the form of a refund, withdrawal, or other credit.
- f. Post-Retirement Health Benefits. Post-retirement health benefits (PRHB) refers to costs of health insurance or health services not included in a pension plan covered by Section VI(14)(e) for retirees and their spouses, dependents, and survivors. PRHB costs may be computed using an acceptable actuarial cost method recognized by GAAP in accordance with established written policies of the unit.
1. PRHB costs calculated using an actuarial cost method recognized by GAAP are allowable if they are funded for that year within six months after the end of that year. Costs funded after the six-month period (or a later period agreed to by HHSC) are allowable in the year funded.
 2. Amounts funded in excess of the actuarially determined amount for a fiscal year may be used as the MCO's contribution in a future period.
 3. To be allowable in the current year, the PRHB costs must be paid either to:
 - (a) The MCO or other benefit provider as current year costs or premiums, or
 - (b) The MCO or trustee to maintain a trust fund or reserve for the sole purpose of providing post-retirement benefits to retirees and other beneficiaries.
 4. The Contract must receive an equitable share of any amounts of previously allowed post-retirement benefit costs (including earnings thereon) that revert or inure to the MCO in the form of a refund, withdrawal, or other credit.

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1. Payments in addition to regular salaries and wages made to workers whose employment is being terminated are allowable to the extent that, in each case, they are required by (a) law, (b) employer-employee agreement, or (c) established written policy.
2. Severance payments (but not accruals) associated with normal turnover are allowable. Such payments must be allocated to all applicable activities of the MCO as an indirect cost.
3. Abnormal or mass severance pay will be considered on a case-by-case basis and is generally unallowable; any exceptions would require advance review by HHSC and would be subject to audit.

h. Support of Salaries and Wages. These standards regarding time distribution are in addition to the standards for payroll documentation.

1. Charges to the Contract for salaries and wages, whether treated as direct or indirect costs, will be based on payrolls documented in accordance with generally accepted practice of the unit and approved by a responsible official(s) of the MCO.
2. Where employees of the MCO, or an Affiliate, work on multiple activities, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation that meets the standards in Section VI(14)(h)(3) (unless a substitute system has been reviewed in advance by HHSC) and will be subject to HHSC audit. Documentary support will be required for all employees within the MCO and its Affiliates working on activities related to the Contract.
3. Personnel activity reports or equivalent documentation must meet the following standards:
 - (a) They must reflect an after-the-fact distribution of the actual activity of each employee,
 - (b) They must account for the total activity, for which each employee is compensated,
 - (c) They must be prepared at least monthly and must coincide with one or more pay periods, and
 - (d) They must be signed by the employee.
4. Budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to the Contract but may be used for interim accounting purposes, provided that:
 - (a) The MCO's system for establishing the estimates produces reasonable approximations of the activity actually performed; and
 - (b) At least quarterly, comparisons of actual costs to budgeted distributions based on the monthly activity reports are made and adjustments to actual costs are recorded.

i. Employee Incentive Payments.

Employee incentive payments are allowable if they are:

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1. Part of and in conformance with an existing plan that has been submitted at least nine months in advance to HHSC, and which is in compliance with any relevant specific terms of the Contract, such as those describing the criteria required for an employee incentive payment plan;
 2. Based on individual or group performance with respect to clearly-stated goals within a defined period (generally either the MCO's fiscal year, the MCO Parent's fiscal year, the calendar year, or the FSR reporting period);
 3. Paid after the end of and within 90 days of the defined period, and is not contingent upon future services any recipient would provide; and
 4. Paid to individuals whose activities support the MCO in the execution of its responsibilities under the Texas managed care contract(s).
15. Contingencies. Contributions to a contingency reserve or any similar provision, which is created to cover the costs of events or occurrences that cannot be foretold with certainty as to time, or intensity, or with an assurance of their happening, are unallowable. The term "contingency reserve" excludes self-insurance reserves (see Section VI(28)(d)), pension plan reserves (see Section VI(14)(e)), and post-retirement health and other benefit reserves (see Section VI(14)(f)) computed using acceptable actuarial cost methods.
16. Contributions and Donations. Contributions and donations, including cash, property, and services, regardless of the recipient, are unallowable.
17. Cost of capital. Expenses representing the cost of capital in any manner are unallowable.
18. Defense and Prosecution of criminal proceedings, civil proceedings, and claims are generally unallowable.
- a. An exception exists for an MCO to identify, investigate, or pursue recoveries relating to suspected Fraud, Abuse, or Waste of providers or unaffiliated subcontractors providing services under the Texas Medicaid/CHIP contracts, as well as to assist with the prosecution of suspected Fraud, Abuse, or Waste with these providers or unaffiliated subcontractors. This exception includes reasonable associated costs incurred in:
 1. identifying, investigating, or pursuing Fraud, Waste, or Abuse under the Texas Medicaid/CHIP contracts;
 2. any related cooperation with or assistance provided to any state or federal agency; and
 3. related defense costs that arise as a result of actions against providers and unaffiliated subcontractors.Costs incurred under this exception do not have to result in actual recoveries in order to qualify.



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- b. An exception exists for reasonable legal costs related to subrogation, third party recoveries, and provider credentialing matters, which are allowable if these costs are incurred directly in the administration of the Contract with HHSC. However, no exception extends to the payment by the MCO or any Affiliate of any fines, penalties, settlements, imposed court costs or attorney fees, sanctions, damages, interest, or related types of expenses. Legal or related costs are not allowable for prosecution of claims against a state or the Federal government or other governmental body; or in connection with any criminal, civil, or administrative proceeding commenced by a state or Federal government or any other governmental body.

19. Depreciation and Amortization.

- a. Depreciation and amortization are a means of allocating the cost of fixed assets and intangible assets to periods benefiting from asset use, respectively. Depreciation for a particular class of assets (e.g., buildings, office equipment, computer equipment) and amortization for a particular class of assets (e.g. patents, leasehold improvements) charged to the Contract must be determined on the same basis used for the entity-wide financial statements.
- b. The computation of depreciation must be based on the acquisition cost of the assets involved. The value of an asset donated to the unit by an unrelated third party must be its fair market value at the time of donation.
- c. Charges for depreciation and amortization must be supported by adequate property records, including the amount of depreciation and amortization taken each period.
- d. Charges for amortization of intangible assets are allowable only to the extent that they represent direct costs for the acquisition of proprietary processes (patents, copyrights, etc.) to be used exclusively in fulfilling the objectives of the Contract. Charges for amortization of intangible assets not related to proprietary processes, such as goodwill and debt acquisition costs, are unallowable.

20. Employee Health and Welfare Costs. The costs of health or first-aid clinics or infirmaries, employee counseling services, employee information publications, and any related expenses incurred in accordance with the MCO's policy are allowable. Income generated from any of these activities will be offset against expenses.

21. Entertainment. Costs of entertainment, including amusement, diversion, and social activities and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities) are unallowable.

22. Fines and Penalties. Fines, penalties, damages, and other settlements resulting from violations (or alleged violations) of, or failure of the unit to comply with, Federal, State, or local laws and regulations, are unallowable except when incurred as a result of compliance with specific provisions of the Contract or written instructions by HHSC authorizing such payments in advance.

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23. Income taxes. Federal, state, and local taxes on income are unallowable. This includes excess profit taxes; corporate income taxes paid by a parent; and other income taxes paid by a parent or other Affiliate.
24. Investment Management Costs. Costs of investment counsel and staff and similar expenses incurred to enhance income from investments are unallowable.
25. Liquidated Damages paid to the Health and Human Services Commission cannot be paid with premium dollars or with investment funds received on premiums. Liquidated Damages must come from other resources of the MCO. Liquidated Damages are unallowable.
26. Losses on Disposition of Depreciable Property and other capital assets are unallowable.
27. Idle Facilities and Idle Capacity.
- a. As used in this Section the following terms have the meanings set forth below:
 1. Facilities means land and buildings or any portion thereof, equipment individually or collectively, or any other tangible capital asset, wherever located, and whether owned or leased by the MCO.
 2. Idle facilities means completely unused facilities that are excess to the MCO's current needs.
 3. Idle capacity means the unused capacity of partially used facilities. It is the difference between (a) that which a facility could achieve under 100 percent operating time on a one-shift basis less operating interruptions resulting from time lost for repairs, setups, unsatisfactory materials, and other normal delays, and (b) the extent to which the facility was actually used to meet demands during the accounting period. A multi-shift basis should be used if it can be shown that this amount of usage would normally be expected for the type of facility involved.
 4. Cost of idle facilities or idle capacity means costs such as maintenance, repair, housing, rent, and other related costs, e.g., insurance, interest, and depreciation or use allowances.
 - b. The costs of idle facilities are unallowable.
28. Insurance and Indemnification.
- a. Costs of insurance that is required and maintained pursuant to the Contract are allowable but subject to audit.
 - b. Costs of other insurance in connection with the general conduct of activities are allowable if the types, extent, and cost of coverage are in accordance with the MCO's policy and sound business practice.
 - c. Actual losses that could have been covered by permissible insurance (through a self-insurance program or otherwise) are unallowable, unless expressly provided for in the Contract or as described below. Costs incurred because of losses not covered under nominal deductible insurance coverage provided in keeping with

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sound management practice, and minor losses not covered by insurance, such as spoilage, breakage, and disappearance of small hand tools which occur in the ordinary course of operations, are allowable.

- d. Contributions to a reserve for certain self-insurance programs including workers' compensation, unemployment compensation, and severance pay are allowable subject to the following provisions.
 1. The type of coverage, the extent of coverage, and the rates and premiums would have been allowed had insurance (including reinsurance) been purchased to cover the risks. However, provision for known or reasonably estimated self-insured liabilities, which do not become payable for more than one year after the provision is made, must not exceed the discounted present value of the liability. The rate used for discounting the liability must be determined by giving consideration to such factors as the settlement rate for those liabilities and its investment rate of return.
 2. Earnings or investment income on reserves must be credited to those reserves.
 3. Contributions to reserves must be based on sound actuarial principles using historical experience and reasonable assumptions. Reserve levels must be analyzed and updated at least biennially for each major risk being insured and take into account any reinsurance, coinsurance, etc. Reserve levels related to employee-related coverage will normally be limited to the value of claims (a) submitted and adjudicated but not paid, (b) submitted but not adjudicated, and (c) incurred but not submitted. Reserve levels in excess of the amounts based on the above must be identified and justified in the cost allocation plan or indirect cost rate proposal.
 4. Accounting records, actuarial studies, and cost allocations (or billings) must recognize any significant differences due to types of insured risk and losses generated by the various insured activities or agencies of the governmental unit. If the MCO experiences significantly different levels of claims for a particular risk, those differences are to be recognized by the use of separate allocations or other techniques resulting in an equitable allocation.
 5. Whenever funds are transferred from a self-insurance reserve to other accounts (e.g., general fund), refunds must be made to HHSC for its share of funds transferred, including earned or imputed interest from the date of transfer.
- e. Actual claims paid to or on behalf of employees or former employees for workers' compensation, unemployment compensation, severance pay, and similar employee benefits (e.g., post retirement health benefits), are allowable in the year of payment provided (1) the MCO follows a consistent costing policy, and (2) they are allocated as a general administrative expense to all activities of the MCO.
- f. Insurance refunds must be credited against insurance costs in the year the refund is received.

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g. Indemnification includes securing the MCO against liabilities to third persons and other losses not compensated by insurance or otherwise. HHSC is obligated to indemnify the MCO only to the extent expressly provided for in the Contract.

29. Interest. In general, interest expense is unallowable. This includes interest expense incurred by a parent or other Affiliate. Costs incurred for interest on borrowed capital or the use of the MCO's own funds, however represented, are unallowable, except as provided in Section VI(41)(d) (regarding rental costs for certain leases).

30. Lobbying. The cost of activities associated directly or indirectly with influencing local state or federal legislation is an unallowable cost.

31. Maintenance, Operations, and Repairs. Unless prohibited by law, the cost of utilities, insurance, security, janitorial services, elevator service, upkeep of grounds, necessary maintenance, normal repairs and alterations, and the like are allowable to the extent that they: (1) keep property in an efficient operating condition, (2) do not add to the permanent value of property or appreciably prolong its intended life, and (3) are not otherwise included in rental or other charges for space. Costs that add to the permanent value of property or appreciably prolong its intended life must be treated as capital expenditures.

32. Marketing, Advertising, and Public Relations Costs.

a. Applicability

This Section describes the advertising, marketing, promotional, outreach, and public relations activities (collectively "marketing activities") that an MCO is permitted to *record as an allowable expense* on the FSRs. For rules concerning *permissible* marketing activities, refer to Uniform Managed Care Manual (UMCM) Chapter 4.3, "Marketing Policies and Procedures." A marketing activity may be permissible under Chapter 4.3, but not an allowable expense for purposes of FSR reporting. A communication from HHSC regarding specific permitted marketing practices does not override language in this Section regarding the allowability of expenses.

This Section describes the costs allowable for inclusion on the FSR, and the specific line items for recording those costs on the FSR.

b. Costs That Are Allowable as Marketing Expenses on the FSR

The following costs are allowable as deductible expenses on the FSR, subject to the limitations as listed under Section VI(32)(d), "Unallowable Costs". MCO should record the following costs on the Marketing Expenses line item on the FSR.

1. Advertising Costs, when incurred by the MCO for promotional and outreach efforts, if all three of the following criteria are met:

(i) an HHSC Program that the MCO participates in is mentioned within the promotional or outreach materials;

(ii) the advertising (or related activity) is not in violation of UMCM Chapter 4.3; and

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- (iii) the primary target audience consists of Medicaid or CHIP Program eligibles in Texas.
2. Other Marketing Costs, when incurred by the MCO for the following items:
- (i) member surveys;
 - (ii) member focus groups and advisory committees;
 - (iii) materials or events oriented specifically at member education or community health education;
 - (iv) Marketing Incentives (as defined in UMCM [Chapter 4.3](#));
 - (v) non-cash promotional items and giveaways valued at \$10 or less each, that are distributed solely to current or prospective Texas Medicaid or CHIP members or their families; or
 - (vi) reasonable payments for booth rentals at events attended by the MCO for member outreach purposes, which events are attended by prospective Texas Medicaid or CHIP members or their families.
- c. Related Costs That Are Allowable on the FSR, But Not as Marketing Expenses
- The following costs are allowable as deductible expenses on the FSR, subject to the limitations as listed under Section VI(32)(d), "Unallowable Costs," but should NOT be recorded on the Marketing Expenses line item on the FSR.
1. Provider directories, provider manuals, and member handbooks. These items are not considered to be Marketing Expenses for FSR reporting purposes. Costs associated with directories, manuals, and handbooks should be recorded under Printing or Postage, as may be appropriate. If an external firm handles some of this effort, the Outsourced Services line item may be utilized for the appropriate portion of those costs. Any allowable related costs that do not fit under these line items should be recorded under Other Administrative Services.
 2. Mailing and printing costs for correspondence with current members. These items are not considered Marketing Expenses, unless a specific effort is primarily oriented towards member retention or member renewal. Allowable costs associated with these items should be recorded in the same manner described above for directories, provider manuals, and handbooks.
 3. Certain non-marketing Advertising Costs, when incurred by the MCO for:
 - (i) the recruitment of personnel to perform services for the HHSC Program(s);
 - (ii) the procurement of goods and services for the HHSC Program(s);
 - (iii) the disposal of surplus materials directly by the MCO; or
 - (iv) certain limited other cases, where the incurrence of Advertising Costs are necessary to meet the requirements of the Contract with HHSC.These non-marketing Advertising costs should be recorded as Other Administrative Expenses.
 4. Public Relations Costs incurred by the MCO as a direct, non-allocated cost for public relations activities are allowable in the following circumstances:
 - (i) public relations activities required by the Contract with HHSC;



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- (ii) costs incurred to communicate with the public and press pertaining to specific activities, accomplishments, or outcomes that result from performance of services under the Contract with HHSC, as long as the MCO includes the name of the applicable HHSC Program(s);
- (iii) costs related to the Contract with HHSC that are incurred to:
 - (A) respond to inquiries on the MCO's policies and activities;
 - (B) communicate with the public and press; or
 - (C) conduct general communication with news media, to the extent that the activities are limited to communication necessary to keep the public informed on matters of public concern such as notice of contract awards, facility closings or openings, employee layoffs or rehires, financial information; and
- (iv) costs of MCO participation in community service activities (e.g., blood bank drives, charity drives, disaster assistance).

Valid Public Relations costs should be recorded in the FSR on appropriate line items similar to as described under website hosting costs in this Section.

5. Basic website costs, including home-site hosting, site maintenance, etc. These items are not considered Marketing Expenses, unless the cost is dedicated to the procurement of internet advertising. Hosting and maintenance should be recorded under Salaries for that portion that represents in-house efforts, to Outsourced Services for appropriate external fees, and otherwise to Other Administrative Expenses.
6. Marketing-related and Public Relations related overhead allocations (or assessments), from a parent (or other Affiliate). Such allocations and assessments generally should be recorded under Affiliate Allocations/Charges. An exception to this would be for a cost that solely represents a direct net payment to an unaffiliated third party, wherein the payment is specifically for advertising directed to Program-eligible populations in Texas, in which an HHSC Program is mentioned.
7. Costs of professional and industry organizations, associations, and periodicals, including memberships, subscriptions, meeting costs, and associated dues, fees, contributions, reimbursements, etc. Valid costs associated with these professional association items should be recorded under Other Administrative Expenses.
8. Other related marketing and advertising type costs that are allowable per this Chapter, but excluded from being reported on the Marketing Expense line, should be reported on the FSR under Other Administrative Expenses if the MCO determines that no other line item is appropriate.

d. Unallowable Costs

Advertising Costs, Public Relations Costs, and Other Marketing Costs that are not allowable expenses on the FSR include the following.

1. Any media or efforts that do not mention an HHSC Program. An exception to this is non-cash promotional items and giveaways valued at \$10 or less each,

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- which are distributed solely to current or prospective Texas Medicaid or CHIP members or their families.
2. Any activity that does not comply with UMCM Chapter 4.3.
 3. Any costs associated with any of the following:
 - (i) any written or oral statements containing material misrepresentations of fact or law, or that are in any manner determined by HHSC to be significantly misleading;
 - (ii) usage of "Spam," as defined by UMCM Chapter 4.3;
 - (iii) materials used or efforts directed, in whole or in part, at anything unrelated to the applicable HHSC Program;
 - (iv) activities outside the State of Texas;
 - (v) royalty fees or franchise fees;
 - (vi) gifts or gratuities (excluding certain low-cost-per-item mass-produced promotional giveaway items, as may be allowed under the requirements of Section VI(32)(b)(2));
 - (vii) charitable donations of any kind, including cash contributions to non-profit organizations, and paid sponsorships;
 - (viii) Value-Added Services;
 - (ix) the costs of conventions, retreats, gatherings, parties, awards presentations, appreciation events, celebrations, entertainment, non-outreach activities, internal meetings, or events related to internal activities of the MCO or its Affiliates;
 - (x) expenses related to events described in Section VI(32)(d)(3)(ix) above, including costs associated with displays, demonstrations, and exhibits; costs of meeting rooms and hospitality suites; and any related airfare, lodging, meals, car rental, fuel, taxi, mileage, parking, laundry, entertainment, and other travel expenses;
 - (xi) unsolicited direct mail to non-members; cold-calling; door-to-door marketing; or acquisition or development of non-member mailing lists;
 - (xii) fees (including assessments, allocations, overhead, or other charges) invoiced from a parent organization (or other Affiliate), for any advertising related costs, public relations related costs, or other marketing expenses. An exception to this would be where any costs pertain directly and solely to an HHSC Program, and represent only the direct net external payment to an unaffiliated third party.
 4. Costs of memberships in civic or community organizations, including dues and expenses associated with country club and fraternal organizations.
 5. Political contributions or costs associated with lobbying, and any costs associated with elected officials or candidates.
 6. Any costs or activities that do not comply with 2 C.F.R. Part 200 or the Federal Acquisition Regulations (FAR), including 42 C.F.R. § 438.104.
- 33. Materials and Supplies.** The cost of materials and supplies is allowable. Purchases should be charged at their actual prices after deducting all cash discounts, trade

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discounts, rebates, and allowances received. Withdrawals from general stores or stockrooms should be charged at cost under any recognized method of pricing, consistently applied. Incoming transportation charges are a proper part of materials and supply costs.

34. Memberships, Subscriptions, and Professional Activities.

- a. Costs of the MCO's memberships in business, technical, and professional organizations are allowable.
- b. Costs of the MCO's subscriptions to business, professional, and technical periodicals are allowable.
- c. Costs of meetings and conferences where the primary purpose is training or the dissemination of technical information, including meals, transportation, rental of meeting facilities, and other incidental costs are allowable, subject to the limitations of Section VI(47), "Travel Costs."
- d. Costs of membership in civic and community social organizations are unallowable.
- e. Costs of membership in organizations substantially engaged in lobbying are unallowable.

35. Motor Pools. The costs of a service organization that provides automobiles to the MCO at a mileage or fixed rate or provides vehicle maintenance, inspection, and repair services are allowable.

36. Pre-implementation Costs. Pre-implementation costs are certain costs incurred between the date of tentative Contract award, and the Effective Date of the Contract. Pre-implementation costs are allowable if such costs are expensed to Rate Period 1, included in the first full quarterly FSR submission, and meet all of the following criteria.

- a. The costs are Reasonable Costs and would otherwise be allowable (if they had been incurred on or after the Effective Date) under the provisions of the Contract, and are necessary for the MCO to implement the Contract.
- b. The costs are Direct Costs under the provisions of the Contract.
- c. The costs are incremental. A cost is incremental if it would not have been incurred by the MCO in the absence of the Contract. For example, allocations of compensation costs for individuals who were employed by the MCO prior to or commensurate with the Effective Date of the Contract are reimbursable only if:
 - (1) the MCO can demonstrate that the employees were hired solely to provide services under the Contract, or received additional compensation (such as overtime) for services directly related to implementation of the Contract, or
 - (2) the MCO can support that the employees did work on Contract issues evidenced by supporting documentation such as time and attendance sheets or monthly work analysis worksheets.

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Any allocated expenses (such as postage, office supplies, telephone, utilities, and printing) must be supported by an allocation methodology and documentation that the expense was necessary for Contract implementation.

- d. If costs are paid or payable, directly or indirectly, to an Affiliate, supporting documentation must reflect that the MCO has not included on the FSR reporting any amounts paid to Affiliates for goods and services that would be deemed unallowable expenditures under the Contract (if they had been incurred on or after the Effective Date). See Section I(D), "Affiliate transactions and Affiliate cost reporting."

Pre-implementation costs require submission of a specified spreadsheet and other documentation as may be prescribed by HHSC or its auditor. There are certain limitations for these costs in terms of the potential carry-forward of any Rate Period 1 losses.

Costs incurred prior to the notification of Contract award, which may be incurred in anticipation of the award of the Contract, or in connection with Contract negotiations, bid preparation, or RFP submission, etc., are unallowable.

Expenses must be reported for each month in which the expenses were incurred and must be reported to HHSC in a designated format. These expenses must be counted toward the calculation of total expenses for the first FSR reporting period for the purposes of calculating the net income before taxes. These expenses must not be allocated or amortized beyond the first FSR reporting period.

37. Professional Service Costs.

- a. Costs of professional and consultant services rendered by persons or organizations that are members of a particular profession or possess a special skill, whether or not officers, are professional services costs. Cost of professional and consultant services rendered by persons or organizations who are not officers or employees of the MCO, are allowable if they: are reasonable in relation to the services rendered; are not contingent upon recovery of the costs from HHSC; and do not conflict with any other provisions of this Chapter.
- b. Retainer fees supported by evidence of bona fide services available or rendered are allowable.

38. Proposal Costs. Costs of preparing proposals for potential contracts are unallowable.

39. Publication and Printing Costs. Publication costs, including the costs of printing (including the processes of composition, plate-making, presswork, binding, and the end products produced by such processes), distribution, promotion, mailing, and general handling are allowable.

40. Rebates and profit sharing. Unless specifically allowed by the HHSC contract (e.g., Pharmacy rebates), any profit sharing or rebate arrangement between the contractor and a subcontractor is unallowable. Likewise, any fees or assessments between an operating subsidiary and an Affiliate, which are not tied to specifically identified

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services that directly benefit the contract, such that the fee is effectively a form of profit payment or rebate to the Affiliate, are unallowable unless specifically allowed by the HHSC contract.

41. Rental Costs.

- a. Subject to the limitations described in Sections VI(41)(b) through (41)(d), rental costs are allowable to the extent that the rates are reasonable when considering: rental costs of comparable property, if any; market conditions in the area; alternatives available; and the type, life expectancy, condition, and value of the property leased.
- b. Rental costs under sale and leaseback arrangements are allowable only up to the amount that would be allowed had the MCO continued to own the property.
- c. Rental costs under less-than-arms-length leases are allowable only up to the amount that would be allowed had title to the property vested in the MCO. For this purpose, less-than-arms-length leases include those where:
 1. One party to the lease is able to control or substantially influence the actions of the other;
 2. Both parties are parts of the same MCO or are Affiliates; or
 3. The MCO creates an authority or similar entity to acquire and lease the facilities to the MCO and other parties.
- d. Rental costs under leases required to be treated as capital leases under GAAP, are allowable only up to the amount that would be allowed had the MCO purchased the property on the date the lease agreement was executed. This amount would include expenses such as depreciation, interest, maintenance, and insurance. The provisions of Financial Accounting Standards Board Statement 13 must be used to determine whether a lease is a capital lease.

42. Retrocession Agreements. “Retrocession” refers to a transaction where a reinsurer cedes or transfers back to the insured or its designee all or part of the reinsurance that the reinsurer previously assumed. While the reinsurer is “providing” ongoing reinsurance to the insured in one contract, it is simultaneously relieving itself of all or part of that reinsurance obligation in another contract. In conjunction with this transfer of risk away from the reinsurer, a retrocession agreement may involve the return of reinsurance premiums back to the insured or its designee, or the remitting of other payments from the reinsurer to the insured or its designee, that have the effect of substantially offsetting or reducing the gross amount that had been paid to the reinsurer by the insured in the original reinsurance.

Any retrocession agreement that would impact FSR reporting and that fails to strictly meet the requirements of this Chapter prior to audit may be deemed a material breach of the Contract. A retrocession agreement may be permissible under the Contract only if it meets all the criteria listed in this Section.

Any retrocession payments made by a reinsurer or its Affiliate that are related in any manner to the costs incurred or services performed under the MCO Contract, and

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which payments are or may be received by an MCO or an Affiliate, must be included in the FSR as a “contra-cost,” or an offset to other reported costs, thus reducing overall expenses reported. Any retrocession payments that are contractually required due to activity in a given State Fiscal Year (SFY) must be reported in that SFY’s FSR reporting, even if the payments are not received until a subsequent SFY. Retrocession agreements may not be utilized to shift FSR-reported profitability either between years or out of the MCO.

Copies of all retrocession agreements relating to the MCO Contract must be sent to HHSC, including any amendments or renewals. Retrocession agreements, amendments, and renewals must receive HHSC’s prior written approval and are subject to audit. These requirements also apply to any retrocession agreement (or payment) between an Affiliate and a third party, if the agreement (or payment) would affect the reported cost on the FSR. These requirements apply to any “interests and liabilities contract” associated with any reinsurance agreement; “excess of loss reinsurance binder;” reinsurance-related “experience refunds;” and other arrangements that may affect similar mechanisms. These requirements also apply to any agreement or arrangement with a third party that wholly or partially negates, or significantly offsets, any reinsurance with the third party or any of its affiliates.

43. Risk Mitigation. Risk mitigation refers to the shifting of financial risk to another entity, in exchange for a payment. For purposes of FSR reporting, a reinsurance arrangement will be considered to have accomplished “risk mitigation” only to the extent that the arrangement shifts risk to a non-Affiliate. Further, retrocession arrangements may have the effect of cancelling all or part of the risk mitigation.
44. Royalty Agreements (including associated fees, payments, expenses, and premiums). Payments to an Affiliate for any form of royalty are unallowable. This includes fees, payments, expenses, premiums, assessments, and overhead allocations to recognize the advantage or value of proprietary systems, business products, processes, and methodologies; intellectual property; brand name recognition; logos; experience and expertise; and ability to raise capital. Costs for these items are unallowable, regardless of whether they are labeled as royalty payments.
45. Taxes.
 - a. Income taxes and state franchise taxes are unallowable.
 - b. In general, other taxes that the MCO is legally required to pay, such as the Health Insurance Providers Fee imposed by Section 9010 of the Patient Protection and Affordable Care Act and Section 1406 of the Health Care and Education Reconciliation Act of 2010, are allowable.
 - c. Gasoline taxes, motor vehicle fees, and other taxes that are in effect user fees for benefits provided to the federal government are allowable.
 - d. Applicable Premium and Maintenance taxes are an allowable charge to the Contract.

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- e. This provision does not restrict HHSC's authority to identify taxes where state participation is inappropriate. Where the identification of the amount of unallowable taxes would require an inordinate amount of effort, HHSC may accept a reasonable approximation of the unallowable amount.

46. Training. The cost of training provided for employee development is allowable.

47. MCO Travel costs.

- a. General. Travel costs are allowable only as a direct cost for expenses for transportation, lodging, subsistence, and related items incurred by employees traveling on official business specifically related to the program. Travel costs related to employee training are allowable. Such costs may be charged on an actual cost basis, on a per diem or mileage basis in lieu of actual costs incurred, or on a combination of the two, provided the method used is applied to an entire trip, and results in charges consistent with those normally allowed in like circumstances in all other activities of the MCO.
- b. Lodging and subsistence. Costs incurred by employees and officers for travel, including costs of lodging, other subsistence, and incidental expenses, will be considered reasonable and allowable only to the extent the costs do not exceed charges normally allowed by the MCO in its regular operations as a result of the MCO's policy. In the absence of a written policy regarding travel costs, the rates and amounts of travel will be allowed only as part of a plan reviewed in advance by HHSC and subject to audit.
- c. Commercial air travel. Airfare costs in excess of the customary standard (coach or equivalent) airfare are unallowable.
- d. Air travel by other than commercial carrier. Cost of travel by the MCO-owned, -leased, or -chartered aircraft, as used in this Section, includes the cost of lease, charter, operation (including personnel costs), maintenance, depreciation, interest, insurance, and other related costs. Costs of travel via the MCO-owned, -leased, or -chartered aircraft are unallowable to the extent they exceed the cost of allowable commercial air travel, as provided for in Section VI(47)(c).

VII. Other Costs

Failure to mention a particular item of cost in this document is not intended to imply that it is either allowable or unallowable; rather, determination of allowability in each case should be based on the treatment or standards provided for similar or related items of cost. To be allowable as expenses under the Contract, costs must meet the following general criteria.

- a. Be a reasonable cost under the provisions of the Contract and be necessary for proper and efficient performance and administration of the Contract.
- b. Be an allocable cost under the provisions of the Contract.
- c. Be authorized or not prohibited under state or local laws or regulations.

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- d. Conform to any limitations or exclusions set forth in these principles, terms and conditions of the Contract, laws, or other governing regulations as to types or amounts of cost items.
- e. Be consistent with policies, regulations, and procedures that apply uniformly to both the Contract and other activities of the MCO.
- f. Be accorded consistent treatment. A cost may not be assigned to the Contract as a direct cost if any other cost incurred for the same purpose in like circumstances has been allocated to the Contract as an indirect cost.
- g. Except as otherwise provided for in the Contract, be determined in accordance with Generally Accepted Accounting Principles.
- h. Not be included as a reimbursable cost or used to meet cost sharing requirements of any other activity of the MCO during the Contract period.
- i. Be net of all applicable credits.
- j. Be adequately documented.
- k. Affiliate costs must meet the same allowability requirements as those for the MCO. Other than the exceptions described in Section I(D), Affiliate costs must represent a pass-through of actual costs incurred by the Affiliate, with no mark-up.

Any legal commitments to make any payments to other parties (or any actual payments made to other parties) do not overrule the requirements described in this Chapter.

VIII. Quality Improvement Costs

This section identifies the costs that are eligible for treatment as a Quality Improvement Cost in compliance with Centers for Medicare and Medicaid (CMS) rules for managed care organizations.

Under the rules, Quality Improvement Costs (QI), which were previously accounted for as administrative expenses, can be treated as medical expense for purposes of calculating the MCO's Medical Loss Ratio (MLR).

In general the types of expenses that qualify as QI costs are activities that:

- Improve health quality and health outcomes
- Increase the likelihood of good health outcomes
- Are grounded in evidence-based medicine, widely accepted best clinical practices

Examples of the types of activities that may qualify as QI costs are:

- Effective case management
- Patient interaction - education and counseling
- Quality reporting
- Discharge planning
- Health Information Technology to support these activities
- Wellness assessments



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The above list is representative of the types of activities that qualify for QI treatment. It is not an exhaustive list and the relevant CMS regulations provide more detailed guidance.

There are certain activities that are specifically excluded from QI treatment:

- Activities to control or contain costs
- Maintaining a claims adjudication system
- Retrospective and concurrent utilization review
- Provider credentialing
- Marketing
- Any activity that does not improve health quality

The relevant citations that provide definitions are:

45 C.F.R. §§ 158.150 and 151.

Quality Improvement costs will be reported on a separate FSR and those costs will not be included in the Administrative Cap calculation.