

PHS Act Definitions for Activities that Improve Medical Quality

On April 14, the Federal Register published an notice for comments to PHS Act Section 2718(c) directing the National Association of Insurance Commissioners (NAIC) to establish:

1. uniform definitions of the activities including defining which activities constitute activities that improve quality, and
2. standardized methodologies for calculating measures of these activities that to take into account:
 - a. the special circumstances of smaller plans,
 - b. different types of plans, and
 - c. newer plans

These uniform definitions and standardized methodologies will be subject to the certification of the Secretary.

For years, FASB (Financial Accounting Standards Board) has provided guidelines for SG&A expenses that apply to all industries. With this PHS Act directive, health insurers can convert some SG&A expenses into medical expenses to raise their MLR. Since the law allows activities that improve quality to be considered medical expenses, some SG&A expenses will qualify. What does and does not improve quality and not violate FASB standards is the issue.

Expenses can be divided into variable, semi-variable and fixed. Leases, rents, utilities, and most administrative expenses are considered fixed in that they do not vary materially with sales over shorter periods of months or quarters. Direct costs are clearly variable expenses representing cost of goods or services sold. For health insurers, variable expenses are medical costs. *Virtually all insurers' fixed and variable expenses should continue to be unchanged by this directive.*

Semi-variable expenses are where interpretations can occur. A logical guideline defining activities that improve quality provides some boundaries. ***If the presence of an activity immediately improves quality and the absence results in an immediate drop in quality, that activity would be a valid medical expense.***

Nurse hotlines fit this guideline. *Hotlines for benefits and claims questions* do not. *Wellness programs* fit this guideline provided they include monitoring of participation. Just offering someone a membership to a fitness center does not improve quality if the person does not exercise there.

Less well defined are activities like *nutrition and information technology*. Expenses in these areas may have a positive quality effect in the longer term, but provide no immediate difference. Like R&D, their effects are in the future, and until proven or developed, do not contribute to immediate improvement. Nor will short term activity cutbacks decrease medical quality.

Efforts to reduce *waste, fraud and abuse* would not be a qualified expense. Their goal is to reduce costs, not increase quality. Actuaries that work on developing *new insurance plans* that hopefully bring improved quality likewise have no immediate quality effect and should not qualify. *Advertising effects* are also longer term and costs should not qualify.

Finally, there is *allocated overhead*. Under full absorption rules, all indirect expenses get allocated to operations leaving only profits or losses by lines of business. That the PHS Act should even ask for standard methodologies to identify specific expenses should exclude any allocated overhead. Thus allocating rent, utilities, HR expenses and the like to medical costs should not be allowed.

The only "allocated" expense that may apply would be employee vacation, retirement, and health insurance costs that can be *directly* computed and charged to individuals. But those employees would only include hotline nurses and similar. Nobody in claims, premium, or sales and general administration (non medical activities) would count.

Answers.com – Definition of SG&A Expense

Reported on the Income Statement, it is the sum of all direct and indirect selling expenses and all general and administrative expenses of a company.

Direct selling expenses are expenses that can be directly linked to the sale of a specific unit such as credit, warranty and advertising expenses. Indirect selling expenses are expenses which cannot be directly linked to the sale of a specific unit, but which are proportionally allocated to all units sold during a certain period, such as telephone, interest and postal charges. General and administrative expenses include salaries of non-sales personnel, rent, heat and lights.

DEPARTMENT OF THE TREASURY, Internal Revenue Service, CFR Citation: 26 CFR Part 54

NOTICE: PROPOSED RULES, DOCID: fr14ap10-25

DOCUMENT ACTION: Request for information.

"Section 2718(c) of the PHS Act directs the National Association of Insurance Commissioners (NAIC) to establish uniform definitions of the activities being reported to the Secretary under Section 2718(a), and standardized methodologies for calculating measures of these activities no later than December 31, 2010. Section 2718(c) specifies that NAIC's responsibilities relating to this provision are to include defining which activities constitute activities that improve quality (under Section 2718(a)(2)). Section 2718(c) also directs that the uniform methodologies that NAIC develops are to be designed to take into account the special circumstances of smaller plans, different types of plans, and newer plans. Finally, Section 2718(c) specifies that the uniform definitions and standardized methodologies that NAIC develops are to be subject to the certification of the Secretary."