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Provider Reimbursement Manual - Part 1

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<u>HEADER SECTION NUMBERS</u>	<u>PAGES TO INSERT</u>	<u>PAGES TO DELETE</u>
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	-	1-1 – IM-86-1 (1 p.)
104 – 104.1	1-1.4 – 1-2 (2 pp.)	1-1.4 – 1-2 (2pp.)
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NEW/REVISED MATERIAL--*EFFECTIVE DATE: N/A*

This transmittal updates Chapter 1, Depreciation to reflect a revised Table of Contents without page numbers; correction of typos; and the replacement of Fiscal Intermediary with Contractor. See below for explanation regarding significant revisions, and deletions of obsolete material.

TOC, IM-86-1 is deleted because it is obsolete, per Transmittal 8, chapter 1 of 15-2, July 1988.

Section 104.6, Land (Non-Depreciable), deletes “and return on equity capital under §§202.1 and 203 capital under §§1202.1 and 1218.12 (if applicable).” **Federal Register** §413.157 eliminated the allowance for a return on equity capital for outpatient services furnished on or after January 1, 1988; Chapter 12 will be made obsolete shortly.

DISCLAIMER: The revision date and transmittal number apply to the red italicized material only. Any other material was previously published and remains unchanged

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The principles of reimbursement for provider costs provide that payment for services should include depreciation on all depreciable type assets that are used to provide covered services to beneficiaries. This includes assets that may have been fully (or partially) depreciated on the books of the provider but are in use at the time the provider enters the program. The useful lives of such assets are considered not to have ended and depreciation calculated on a revised extended useful life is allowable. Likewise, a depreciation allowance is permitted on assets that are used in a normal standby or emergency capacity.

The three methods of prorating the cost of depreciable assets are: straight line, declining balance, and sum of the years' digits. For assets acquired after July 1970, however, the use of an accelerated method of depreciation is limited to a declining balance method not to exceed 150 percent of the straight-line rate under the criteria stated in §116C. The depreciation method used under the Medicare program for an asset need not correspond to the method used by a provider for non-Medicare purposes.

102. PRINCIPLES

An appropriate allowance for depreciation on buildings and equipment is an allowable cost. The depreciation must be: (a) identifiable and recorded in the provider's accounting records; (b) based on the historical cost of the asset as defined in §104.10 or, in the case of donated assets, the lesser of the fair market value or the net book value at the time of donation (see §114.2); and (c) prorated over the estimated useful life of the asset using an allowable method of depreciation as described in §116.

Depreciation on assets being used by a provider at the time it enters into the title XVIII program is allowed. This applies even though such assets may be fully or partially depreciated on the provider's books.

For all assets acquired before 1966, the provider, at its option, may choose an allowance for depreciation based on a percentage of operating costs. The operating costs to be used are the lower of the provider's 1965 operating costs or the provider's current year's allowable costs. The percent to be applied is 5 percent starting with the year 1966-67, with such percentage being uniformly reduced by one-half percent each succeeding year. The allowance based on operating costs is in addition to a regular depreciation on assets acquired after 1965. However, when the optional allowance is selected, the combined amount of such allowance on pre-1966 assets and the straight-line depreciation on assets acquired or rented after 1965 may not exceed 6 percent of the provider's allowable cost for the current year.

Depreciation is allowed on assets financed with Hill-Burton or other Federal or public funds.

104. DEFINITIONS

Depreciation is that amount which represents a portion of the depreciable asset's cost or other basis which is allocable to a period of operation. The amount of depreciation is determined by the provider's method of depreciation accounting.

The American Institute of Certified Public Accountants defines depreciation as a process of cost allocation:

"Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of

valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year."

104.1 Depreciable Assets.--Assets that a provider has an economic interest in through ownership (regardless of the manner in which they were acquired) are subject to depreciation. Generally, depreciation is allowable on the assets described below when required in the regular course of providing patient care. Assets which a provider is using under a regular lease arrangement would not be subject to depreciation by the provider. (See §110 on lease-purchase and sale-lease-back agreements.)

In general, assets subject to depreciation are described in the AHA Chart of Accounts for Hospitals, M-58, 15M-8/66-183305, and for the most part are also subject to depreciation for Medicare purposes. However, see the treatment of minor equipment as described below.

104.2 Buildings.--Building includes, in a restrictive sense, the basic structure or shell and additions thereto. The remainder is identified as building equipment.

104.3 Building Equipment.--Building equipment includes attachments to buildings, such as wiring, electrical fixtures, plumbing, elevators, heating system, air conditioning system, etc. The general characteristics of this equipment are: (a) affixed to the building, and not subject to transfer; and (b) a fairly long life, but shorter than the life of the building to which affixed. Since the useful lives of such equipment are shorter than those of the buildings, the equipment may be separated from building cost and depreciated over this shorter useful life.

104.4 Major Moveable Equipment.--The general characteristics of this equipment are: (a) a relatively fixed location in the building; (b) capable of being moved as distinguished from building equipment; (c) a unit cost sufficient to justify ledger control; (d) sufficient size and identity to make control feasible by means of identification tags; and (e) a minimum life of approximately three years. Major moveable equipment includes such items as accounting machines, beds, wheelchairs, desks, vehicles, x-ray machines, etc.

104.5 Minor Equipment.--The general characteristics of this equipment are: (a) in general, no fixed location and subject to use by various departments of the provider's facility; (b) comparatively small in size and unit cost; (c) subject to inventory control; (d) fairly large quantity in use; and, (e) generally, a useful life of approximately 3 years or less. Minor equipment includes such items as waste baskets, bed pans, syringes, catheters, silverware, mops, buckets, etc.

104.6 Land (Non-Depreciable).--Land (non-depreciable) includes the land owned and used in provider operations. Included in the cost of land are the costs of such items as off-site sewer and water lines, public utility charges necessary to service the land, governmental assessments for street paving and sewers, the cost of permanent roadways and grading of a non-depreciable nature, the cost of curbs and sidewalks whose replacement is not the responsibility of the provider, and other land expenditures of a non-depreciable nature. Although land used in the provision of patient care activities is a capital asset, the cost of which is neither depreciable nor amortizable under any circumstances, the historical cost limitations described in §104.10 apply to the valuation of land for purposes of determining allowable interest expense under §§202.1 and 203.

E. For Depreciable Assets Acquired By All Providers On or After December 1, 1997. -- The historical cost of the asset to the acquirer will be the historical cost less depreciation allowed to the owner of record as of August 5, 1997 (or if an asset did not exist as of August 5, 1997, the first owner of record after August 5, 1997). The asset moves from the hands of the seller to the hands of the buyer at the *assets* net book value defined in §104.23. For purposes of this section, the following apply:

1. An asset that was not in existence as of August 5, 1997 includes an asset that physically existed but was not owned by a provider participating in the Medicare program as of that date.

2. The historical cost to the owner of record is subject to the limitation on historical costs described in section B through D of this section, and is reduced by any depreciation taken by the owner of record. The limitation on historical cost is also applied to the purchase of land, which is a capital asset that is neither depreciable nor amortizable under any circumstances. (See §200 ff for application of the limitation to the cost of land for purposes of determining the allowable interest expense.)

3. Historical cost to the owner of record includes the costs of betterments or improvements that extend the estimated useful life, increase the productivity, or significantly improve the safety of an asset. (See §108.2.)

4. For assets acquired prior to a provider's entrance into the Medicare program, the historical cost to the owner of record is the historical cost when acquired, rather than when the provider entered the program.

5. For assets subject to the optional depreciation allowance as described in §413.139, the historical cost to the owner of record is the historical cost established for those assets when the provider changed to actual depreciation as described in §124. If the provider did not change to actual depreciation, as described in §126, for optional allowance assets, the historical cost to the owner of record is based on the provider's recorded historical cost of the asset when acquired. If the provider has no historical cost records for optional allowance assets, the historical cost to the owner of record is established by appraisal.

6. The historical cost of an asset acquired by hospitals and SNFs on or after July 18, 1984 and by all providers on or after December 1, 1997 may not include costs attributable to the negotiation or settlement of the sale or purchase (by acquisition, merger, or consolidation) of any capital asset for which any payment was previously made under the Medicare program. The costs to be excluded include, but are not limited to, appraisal costs (except those incurred at the request of the intermediary under §132.A.1), legal fees, accounting and administrative costs, travel costs, and the costs of feasibility studies. If payment was made for even one cost of this type, all costs of this type must be excluded from the historical cost and are not otherwise allowable.

NOTE: The change in §1861(v)(1)(O) of the Act as amended by §4404 of the Balanced Budget Act (Pub. L. 105-33) has no effect on the recovery of accelerated depreciation as described in §136.

EXAMPLE 1: An SNF was constructed in 1990 for \$25 million by Walter and certified for Medicare participation. It was sold in 1995 for \$30 million to Ed. Because of the limitations in C. above, the allowable acquisition cost to Ed is \$25 million. Ed sells the SNF in 1998 for \$30 million to Zelda. Zelda financed the transaction with \$5 M in cash and \$25 M in bonds. The limitation on the selling price is determined as follows:

Historical Cost to Ed	\$25 million
Salvage Value	\$ 1 million
Estimated useful life	32 years
Depreciation	
$\$25 \text{ M} - \$1 \text{ M} = \$24 \text{ M}$	
$\$24 \text{ M}) 32 =$	\$750,000 per year
Depreciation claimed	\$2, 250,000
Net Book Value on Ed's books	\$22,750,000

There will be no gain or loss on the transaction to Ed. The historical cost to Zelda is \$22,750,000. Zelda's allowable interest expense will be limited to the interest on \$22,750,000, less the \$5,000,000 paid in cash, or \$17,750,000.

EXAMPLE 2: In 1995 Mary buys an SNF for \$55 million from Peter who has owned and operated it under the Medicare program since it was built in 1990. The SNF cost \$50 million to build and its net book value on Pete's books is \$45 million. The allowable acquisition cost to Mary is \$50 million. Mary continues to operate it as a Medicare provider and depreciates it at \$1,250,000 a year.

In 1998 Mary converts it to a noncertified nursing home. At that time her net book value is \$46,250,000. She operates it as such until 1999. She sells it to Paul at the end of 1999 for \$55 million. Her net book value at the date of sale is \$45 million. Paul has it certified for Medicare participation in 2000. Paul's basis is \$45 million, less depreciation taken since his date of purchase.

EXAMPLE 3: In 1990, Sam builds a hospital at the cost of \$14 million. He operates it as a nonparticipating hospital until 1998. At that time he sells it for \$18 million to Melvin. Melvin makes improvements totaling \$3 million and the hospital is certified for Medicare participation in 1999. In 2001 he sells the hospital to Hal for \$30 million. The net book value on Melvin's books is \$18.4 million. There is no gain or loss on the sale. The historical cost to Hal is \$18.4 million.

EXAMPLE 4: Michael buys a SNF in 1983 for \$20 million. He operates it as a Medicare certified facility until 1999, at which time he sells it to Warren for \$6 million. The net book value at the date of sale is \$9 million. There is no gain or loss on the sale. The historical cost to Warren is \$9 million.

104.11 Historical Cost - Trade-Ins.--When an asset is acquired by trading-in an asset that was depreciated under the program, the cost of the new asset is the sum of the undepreciated cost (or fair market value if no cost is assigned) of the asset traded-in and any cash or other assets transferred or to be transferred to acquire the new asset. However, if the asset disposed of was acquired by the provider before its participation in the Medicare program and the sum of the undepreciated cost and the cash or other assets transferred or to be transferred exceeds the list price or fair market value of the new asset, the historical cost of the new asset is limited to the lower of its list price or fair market value.

For assets having no historical or appraisal values assigned, the cost basis is the fair market value at the date of disposal of the old asset plus the sum paid but not to exceed the lower of the list price or fair market value of the new asset.

104.12 Appraisals.--For Medicare purposes, the term "appraisal" refers primarily to the process of establishing or reconstructing the historical cost, fair market value or current reproduction cost of an asset. It includes a systematic, analytic determination and the recording and analyzing of property facts, rights, investments, and values based on a personal inspection and inventory of the property. *(See §134 ff.)*

A. Appraisal Date.--The date selected for establishing the value of fixed assets is called the appraisal date. For example, if December 31, 1967, was established as the appraisal date and the actual physical inventory of fixed assets was taken in February 1968, any additions or dispositions of fixed assets between December 1967 and February 1968 must be taken into account in the appraisal values.

B. Appraised Book Value.--The book value of an asset at the appraisal date is its appraised cost as of the date of acquisition less accumulated depreciation computed on any approved basis up to the appraisal date.

C. Appraisal Expert.--An appraisal expert means an individual or a firm that is experienced and specialized in multi-purpose appraisal of plant assets involving the establishing or reconstructing of the historical cost, fair market value, or current reproduction cost of such assets; employs a specially trained and well supervised staff with a complete range of appraisal and cost construction techniques; is experienced in appraisals of plant assets used by providers; and demonstrates a knowledge and understanding of the regulations involving reimbursement principles, particularly those pertinent to depreciation.

104.13 Lease-Purchase Assets.--If a lease is a virtual purchase as described in §110.B and the lessee becomes the owner of the leased asset, the historical cost of the asset is the sum of the deferred charge (the difference between the amount of the rent paid and the amount of rent allowed as rental expense) and any additional payments made to acquire the assets, subject to the limitation on revaluation of assets. (See §110.B.2.)

104.14 Purchase of Facility as Ongoing Operation.--

A. The historical cost of assets when an ongoing facility is purchased through a bona fide sale is determined as follows:

1. For depreciable assets acquired after July 1, 1966, and prior to August 1970, the sale price or portion thereof attributable to the asset must not exceed the fair market value of the asset at the time of the sale.

2. For depreciable assets acquired after July 1970 and in the case of hospitals and SNFs, before July 18, 1984, the historical cost must not exceed the lowest of (1) the acquisition cost of the asset to the new owner, (2) the current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of the purchase, or (3) the fair market value at the time of the purchase. (See §104.15.)

3. For depreciable assets acquired by hospitals or SNFs on or after July 18, 1984, and not subject to an enforceable agreement, the limitations on historical cost specified in §104.10.C are applicable.

4. For depreciable assets acquired by all providers on or after December 1, 1997, the limitations on historical cost specified in §104.10.E are applicable.

B. For changes of ownership on or after December 1, 1997, no gain or loss is recognized on the sale. For changes of ownership before December 1, 1997, the basis for determining the gain or loss to the seller when the facility was being operated under the program at the time of sale is the sales price.

For assets acquired prior to July 1970, the sale price used by the seller in computing gain or loss for the final cost report must agree with the historical cost used by the new provider in computing depreciation.

For an asset acquired after July 1970, the basis for computing gain or loss to the seller is the sales price without regard to any limitation on the basis for depreciation to the buyer as described in §104.10. (See example 5 in §104.10.C.)

The gain or loss on the sale of each depreciable asset must be determined by allocating the lump sum sale price among all the assets sold (including land, goodwill, and any assets not related to patient care), in accordance with the fair market value of each asset as it was used by the provider at the time of sale. If the buyer and seller cannot agree on an allocation of the sale price, or if they do agree but there is insufficient documentation of the current fair market value of each asset, the intermediary for the selling provider must require an appraisal by an independent appraisal expert to establish the fair market value of each asset and must make an allocation of the sale price in accordance with the appraisal. (See §134 ff.) In any case, the sale price must be allocated among all the assets sold, even when, for example, some of the assets will be disposed of shortly after the sale.

C. If a purchaser cannot demonstrate that the sale was bona fide, the seller's net book value must be used by the purchaser as the basis for depreciation of the asset. In such a case, the purchaser must record the historical cost and accumulated depreciation of the seller recognized under the program, and these are considered as incurred by the purchaser for program purposes, such as application of §§132 ff. (See §1011.4 if related organizations are involved.)

104.15 Fair Market Value.--Fair market value is the price that the asset would bring by bona fide bargaining between well-informed and unrelated buyers and sellers at the date of acquisition. Usually the fair market is the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition.

104.16 Donated Assets.--An asset is considered donated when the provider acquires the asset without making any payment for it in the form of cash, property, or services. When the provider makes any such payment in acquiring the asset, if the payment is less than the fair market value, then

104.19 Salvage Value - Depreciable Assets.--Salvage value is the estimated amount expected to be realized upon the sale or other disposition of the depreciable asset when it is no longer useful to the provider. The amount is ordinarily estimated at the time of acquisition and, except for the declining balance method, is deducted from the cost of the depreciable property to arrive at the basis for depreciation. For example, an asset is purchased for \$17,000 with an expected salvage value of \$2,000. The basis for depreciation becomes \$15,000 (i.e., \$17,000 less \$2,000) for computing the depreciation.

Thus, if a provider disposes of its assets when they are in good operating condition, the salvage value is higher than it might be if the provider used the assets until their inherent life had been substantially exhausted. Virtually all assets have a salvage value substantial enough to be included in calculating depreciation, and only in the rare instance is salvage value so negligible that it may be ignored.

For assets acquired on or after December 1, 1997, and subject to the historical cost limitation in 104.10E and 104.14A.4, salvage value need not be taken.

104.20 Scraping.--Scraping is the physical removal from the provider's premises of tangible personal property which is no longer useful for its intended purpose and is only salable for its scrap or junk value.

104.21 Abandonment.--Abandonment means the permanent retirement of an asset for any future purpose, not merely the provider's ceasing to use the asset for patient care purposes. To claim an abandonment under the program, the provider must have relinquished all rights, title, claim, and possession of the asset with the intention of never reclaiming it or resuming its ownership, possession, or enjoyment.

104.22 Demolition.--The deliberate destruction of a building or other asset resulting in the complete loss of economic value (other than the scrap value) of the asset.

104.23 Net Book Value.--The net book value of the asset is defined as the historical cost under the program less the depreciation recognized under the program.

104.24 Bona Fide Sale.--A bona fide sale contemplates an arm's length transaction between a willing and well informed buyer and seller, neither being under coercion, for reasonable consideration. An arm's-length transaction is a transaction negotiated by unrelated parties, each acting in its own self interest.

106. METHODS FOR WRITING OFF COST OF MINOR EQUIPMENT

Except where prohibited by §108, a provider may treat the cost of the minor equipment needed to operate its facility in any one of the following methods:

(a) The original investment in this equipment is not amortized or depreciated. Any replacements to the base stock are charged to operating expenses. The investment in the base inventory of equipment is adjusted when there is a significant change in the inventory size. For example:

Provider Fiscal Year - July 1 to June 30

Provider Entered Program - July 1, 1966

Original Cost of Minor Equipment in Use at July 1, 1966 - \$15,000

Purchases During FY July 1, 1966, to June 30, 1967 ----- \$10,000

Minor Equipment Inventory Value at June 30, 1967 ----- \$20,000
(Determined for this example to be a significant change in inventory size)

Charges to operating expense in FY ended June 30, 1967, are \$5,000. (Purchases of \$10,000 less increase in inventory value of \$5,000)

(b) The net book value of such items at the time the provider enters the program may be written off ratably over 3 years; that is, one third of the net book value is written off each year. Net book value is the historical cost less previous write-off. The previous write-off should have been computed on the basis of not more than a 3-year life and in equal amounts. A full one-third write-off should have been made in the year of acquisition. If the computation had been based on longer life or a different rate, or both, or if the equipment has been previously written off directly through charges to operating expense, the net book value at the time the provider enters the program is amortized applying a 3-year basis. Thus, any asset over 3 years old, although still in use, is not included. Under this method, any new purchases are also written off ratably over a 3-year period. For example:

Provider Fiscal Year - January 1 to December 31

Provider Entered Program - January 1, 1967

<u>Purchase Date</u>	<u>Acquisition Cost of Minor Equipment in Use on 1/1/67</u>		<u>Recomputed Write-Off To 1/1/67</u>		<u>Net Book Value As Of 1/1/67</u>
1965	\$9,000	minus	\$6,000	equals	\$3,000
1966	6,750	minus	2,250	equals	<u>4,500</u>
				Total	<u>\$7,500</u>

Write-Off allowed on above equipment: 1967 - \$2,500
1968 - \$2,500
1969 - \$2,500

facility" in §1819(j) of the Act, the full circumstances under which it proposes to provide services to beneficiaries on a reasonable cost basis must be reviewed and weighted by the regional office to assure compliance with the Act. Preferably, this is done before an agreement is entered into. However, the certification ordinarily can only be made based upon the on-going operation in order to assure compliance.

113.2 Reimbursement.--When an entire facility or a skilled nursing care distinct-part has been leased by a provider under an arrangement whereby the lessor operates and furnishes essential services, and the lessee requires payments to the lessor that are not representative of the actual cost of the facilities or services furnished by the lessor, the program does not recognize such payments for reimbursement purposes. The program reimburses the lessee only on the basis of the lessor's reasonable costs of furnishing the services. Generally speaking, this involves two cost finding processes - one for the lessor, which requires a determination of cost attributable to the leased distinct-part of the entire facility, if applicable; and one for the lessee's actual operation. The lessor's costs are determined under the Medicare reimbursement principles except that there are no provisions for (1) owner's compensation, or (2) return on equity capital. However, these times are appropriately recognized in the cost finding procedure for the lessee. In addition, any costs for duplicate identifiable services between the lessor and lessee must be eliminated from the lessor's cost.

114. BASIS FOR DEPRECIATION

A. New Assets.--The basis for depreciation of new assets under the straight-line (see §116.1) and the sum-of-the-years' digits (see §116.2) methods is the historical cost of the asset less its salvage value. For the historical cost of donated assets, see §104.16. Section 116B explains the conditions under which the sum-of-the-years' digits method may be used.

Under the declining balance method (see §116.3), the basis for depreciation is the historical cost only. Sections 116B and C explain the applicability and limitation of the use of the declining balance method.

B. Assets Partially or Fully Depreciated on Provider's Books When Provider Enters Program.--For assets that are fully or partially depreciated on the provider's books when the provider enters the program, the basis for depreciation under the straight-line (see §116.1) and the sum-of-the-years' digits (see §116.2) methods is the adjusted historical cost, as defined below, less the salvage value. Section 116B explains the conditions under which the sum-of-the-years' digits method may be used.

Under the declining balance method (see §116.3), the basis for depreciation is the adjusted historical cost only. Sections 116B and C explain the applicability and limitation of use of the declining balance method.

The adjusted historical cost of an asset that is in use when the provider enters the program is its historical cost reduced by the depreciation accumulated up to the date of entrance into the program. Accumulated depreciation for this purpose may be determined on a straight-line basis (regardless of the depreciation method used or in use by the provider) and based on an estimate of the asset's useful life, taking into account past and current information.

When a provider enters the program, it has an opportunity to revise the useful life of its assets taking into account past and current information, subject

to the approval of the intermediary. For example, if an asset currently in use has been fully depreciated on the provider's books, it would be evident that the asset's useful life has not ended. Consequently, a new estimate of the asset's useful life, based on current information, may be made.

When the useful life of an asset is revised, the adjusted historical cost is based on the historical cost reduced by the revised accumulated depreciation based on the new estimate of the asset's useful life. The revised depreciation may be determined on a straight-line basis regardless of the depreciation method used or in use by the provider. The amount of depreciation on the provider's books is not *to be* considered in the determination.

The following illustrates how the basis for depreciation is determined for used assets when a provider enters the program and revises the useful life of an asset.

FACTS

The provider entered the program on July 1, 1993

Asset acquired on July 1, 1987.

Original estimated useful life is 8 years.

Historical cost of the asset	\$1,500,000
Estimated salvage value	\$100,000
Accumulated depreciation on the provider's books, using the straight line method of depreciation	\$1,050,000

When the provider entered the program, it reevaluated the useful life of the asset and estimated that its useful life was 12 years from the date of acquisition. The intermediary approved the change. The basis for depreciation under the program is determined as follows:

Step 1. Determine adjusted historical cost:

Historical cost	\$1,500,000
Less estimated salvage value	<u>100,000</u>
Basis for computing revised accumulated depreciation	<u>\$1,400,000</u>
Revised accumulated depreciation (6/12 x \$1,400,000)	<u>\$700,000</u>
Adjusted historical cost:	
Historical cost	\$1,500,000
Less revised accumulated depreciation	<u>700,000</u>
Adjusted historical cost	<u><u>\$800,000</u></u>

Step 2. Determine basis for depreciation under the program:

Using the straight-line method:	
Adjusted historical cost	\$800,000
Less estimated salvage value	<u>100,000</u>
Basis for depreciation	<u><u>\$700,000</u></u>

NOTE: The method of determining the accumulated depreciation and the adjusted historical cost for depreciation under the program is the same, regardless of the method of depreciation previously used by the provider.

114.1 Transfer of Governmental Facilities.--

A. Intergovernmental Transfer of Facilities.--When assets are transferred from one governmental entity to another under appropriate legal authority, the basis for depreciation is determined as follows.

1. Bona Fide Sale.--The basis for depreciation in a bona fide sale is the historical cost subject to the following limitations.

a. For assets acquired by other than hospitals or SNFs after 1970 and before December 1, 1997, or for assets acquired by hospitals or SNFs after 1970 and before July 18, 1984, the historical cost incurred by the present owner in acquiring the asset under a bona fide sale must not exceed the lower of:

(1) The current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of the purchase; or

(2) Fair market value at the time of the purchase.

b. For assets acquired by hospitals or SNFs on or after July 18, 1984 (see §104.10.C) and before December 1, 1997, the historical cost cannot exceed the lower of:

(1) The allowable acquisition cost, for Medicare purposes, of the asset to the owner of record as of July 18, 1984 (or in the case of an asset not in existence as of July 18, 1984, the first owner of record of the asset after that date);

(2) The acquisition cost of the asset to the new owner; or

(3) The fair market value of the asset on the date of acquisition.

c. For assets acquired by all providers on or after December 1, 1997, the allowable acquisition cost to the acquirer will be the historical cost less depreciation allowed to the owner of record as of August 5, 1997. (See §104.10.E.)

2. Donation.--An asset is considered donated when a governmental entity acquires the asset without assuming the functions for which the transferor used the asset or without making any payment for it in the form of cash, property, or services. To determine the basis for depreciation of a donated asset, see §114.2.

3. If neither items 1 or 2 above applies, i.e., the transfer was solely to facilitate administration or to reallocate jurisdictional responsibility, or the transfer constituted a taking over in whole or in part of the function of one governmental entity by another governmental entity, the basis for depreciation is:

a. For an asset on which the transferor has claimed depreciation under the Medicare program, the transferor's basis under the Medicare program prior to the transfer. The method of depreciation used by the transferee may be the same as that used by the transferor, or the transferee may change the method. (Beginning August 1, 1970, a provider may only change from an accelerated method or optional method to the straight-line method. See §120.)

b. For an asset on which the transferor has not claimed depreciation under the Medicare program, the cost incurred by the transferor in acquiring the asset (not to exceed the basis that would have been recognized had the transferor participated in Medicare program) less depreciation calculated on the straight-line basis over the life of the asset to the time of transfer.

B. Transfer of State Hospital to Nonprofit Corporation Without Monetary Consideration.--If a State transfers a hospital to a nonprofit corporation without monetary consideration on or after July 18, 1984, the depreciable basis of the assets to the new owner is the net book value of the assets as recorded on the State's books at the time of the transfer. For the purpose of this section, monetary consideration includes cash, new debt, and assumed debt.

114.2 Assets Donated to Provider.--Where an asset is donated to a provider as described in §104.16, the basis for depreciation is determined as follows.

1. Assets Not Used or Depreciated Under Medicare Program.--If an asset has never been used or depreciated under the Medicare program and is donated to a provider, the basis for the purpose of calculating depreciation and equity capital (if applicable) is the fair market value of the asset (see §104.15) at the time of donation.

2. Assets Used or Depreciated Under Medicare Program.--If an asset has been used or depreciated under the Medicare program and is donated to a provider or when a provider acquires such assets through estate or intestate distribution, e.g., a widow inherits a skilled nursing facility upon the death of her husband and becomes the owner of a newly certified provider, the basis for the purpose of calculating depreciation and equity capital (if applicable) is *the lesser of:*

- a. The fair market value at the time of donation; or
- b. The net book value in the hands of the owner last participating in the Medicare program.

For donated assets, the basis for depreciation is determined as of the date of donation or the date of death, whichever is applicable. See §104.23 for determining net book value and §104.16 for determining fair market value of donated assets.

When the provider's records do not contain the fair market value of the donated assets as of the date of donation, an appraisal of such fair market value by a recognized appraisal expert is acceptable for depreciation and owner's equity capital purposes.

The provider furnishes its intermediary with information identifying the appraisal expert and type and method of appraisal to be used. The intermediary determines whether the contemplated appraisal is acceptable. (*See §134ff.*)

Allocation of Net Depreciation Adjustment to Each Reporting Period Under the Program.--

(1)	(2)	(3)	(4)	(5)	(6)
Fiscal Year Ending	Actual Depreciation Taken	Recomputed Depreciation	Excess Depreciation (2) - (3)	Gain on Sale	Net Depreciation Adjustment (4) + (5)
6/30/69	\$ 20,000	\$ 10,500	\$ 9,500	\$ 700	\$ 10,200
6/30/70	19,000	10,500	8,500	700	9,200
6/30/71	18,000	10,500	7,500	700	8,200
6/30/72	17,000	10,500	6,500	700	7,200
6/30/73	16,000	10,500	5,500	700	6,200
Total	<u>\$ 90,000</u>	<u>\$ 52,500</u>	<u>\$ 37,500</u>	<u>\$ 3,500</u>	<u>\$ 41,000</u>

D. Allocation Where the Provider is Subject to Capital PPS for Some Reporting Periods Under the Program.--After a hospital becomes subject to the capital PPS, the allocation of the net depreciation adjustment to each reporting period before and after the effective date of capital PPS must be in accordance with §2807.8.

132.4 Methods Available for Determination of Adjustment to Reimbursable Cost.--

A. Paragraph A of §132.3 describes the conditions under which a provider reflects the total net depreciation adjustment as an adjustment of depreciation in the year of disposal. Where these conditions are not met, a provider must first allocate the net depreciation adjustment to periods under the program in accordance with the provisions of paragraph B or C of §132.3. After the net depreciation for each reporting period under the program is determined:

1. The provider will compute the adjustment to reimbursable cost based upon the ratio of the program's share of reimbursable cost to total cost (see paragraph B).
2. On request of the provider, the intermediary may grant permission for the provider to compute the adjustment to reimbursable cost under the method described in paragraph C, if the provider can show that the direct costs of ancillary services furnished under arrangements in any cost reporting period, subject to recovery, are 10 percent or more of the direct costs of all ancillary services furnished.
3. Any provider may at its option compute the adjustment to reimbursable cost by recalculating, for each reporting period, all the necessary cost reporting schedules applicable to each reporting period covered by the depreciation adjustments. Schedules recomputed in accordance with this option must be submitted with the cost report for the cost reporting period in which the gain(s) or loss(es) giving rise to the depreciation adjustments took place.

The same method of computation must be used for all periods affected by the net depreciation adjustments that occur in the current reporting period.

B. Adjustment to Reimbursable Cost Based Upon the Ratio of the Program's Share of Reimbursable Cost to Total Cost.--The adjustment to reimbursable cost is computed by applying the ratio of Medicare reimbursable cost to total allowable cost for each period to the allowable portion of the net depreciation adjustment for that period. The Medicare reimbursable cost and total allowable cost includes inpatient services, nursing salary differential, outpatient and other Part B services, services provided by interns and residents not under an approved training program and ancillary services - Part B. Also, these amounts are gross allowable costs before deductibles and coinsurance billed to HI beneficiaries, return on equity capital, and the charge differential between semiprivate accommodations and less than semiprivate accommodations.

For each period under the program, that portion of the net depreciation adjustment which is applicable to nonallowable cost centers is excluded from the computation. The nonallowable portion is determined by multiplying the net depreciation adjustment for the period by the ratio of depreciation of nonallowable departments to the total depreciation claimed by the provider. See example in C below. To determine the effect on the Part B Trust Fund, the total adjustment to HI reimbursable cost for each period is multiplied by the ratio of Part B reimbursable cost to total reimbursable cost for each of the same periods. The difference between the adjustment to Part B Trust Fund will be the adjustment to Part A Trust Fund. The two examples below include no nonallowable cost centers.

Facts Applicable to Both Examples Below

Cost Report Period <u>Ending</u>	Total Allowable Cost	HI Allowable Cost	Percent HI Cost to Total Allowable Costs
6/30/69	\$640,000	\$320,000	50
6/30/70	\$630,000	\$252,000	40
6/30/71	\$600,000	\$120,000	20
6/30/72	\$580,000	\$104,000	18
6/30/73	\$570,000	\$ 85,500	15

Net Depreciation Adjustment Computed in §132.3B

Cost Report Period <u>Ending</u>	Percent HI Allowable Cost to Total Allowable Cost	Net Depreciation <u>Adjustment</u>	Adjustment to HI Reimbursable <u>Cost</u>
6/30/69	50	\$ 9,020	\$ 4,510
6/30/70	40	\$ 8,610	\$ 3,444
6/30/71	20	\$ 8,200	\$ 1,640
6/30/72	18	\$ 7,790	\$ 1,402
6/30/73	15	\$ 7,380	\$ 1,107
		<u>\$ 41,000</u>	<u>\$ 12,103*</u>

Net Depreciation Adjustments Computed in §132.3C

<u>Cost Report Period Ending</u>	<u>Percent HI Allowable Cost to Total Allowable Cost</u>	<u>Net Depreciation Adjustment</u>	<u>Adjustment to HI Reimbursable Cost</u>
6/30/69	50	\$ 10,200	\$ 5,100
6/30/70	40	\$ 9,200	\$ 3,680
6/30/71	20	\$ 8,200	\$ 1,640
6/30/72	18	\$ 7,200	\$ 1,296
6/30/73	15	\$ 6,200	\$ 930
		<u>\$ 41,000</u>	<u>\$ 12,646*</u>

* This net adjustment is applied as a decrease to the extent of the HI reimbursable cost in the current cost reporting period and any excess not applied is treated as an overpayment to be recovered from the provider.

NOTE: Proprietary providers subject to recapture of accelerated depreciation can determine the effect that the net depreciation adjustment has on the computation of equity capital in accordance with the instructions contained under §136.10 ff. There is no similar prior year adjustment to equity capital for gains and losses on disposal of assets.

C. Apportionment of Net Depreciation Adjustment Based on Routine and Ancillary Utilization.--If the provider can demonstrate to the satisfaction of the intermediary that the method of recovery in B above would be inequitable, and can show that the direct costs of ancillary services furnished under arrangement are 10 percent or more of the direct costs of all ancillary services in any cost reporting period subject to the net depreciation adjustment, the intermediary may grant permission for the provider to compute the recovery under the following method.

- Step 1 - The net depreciation adjustment for each period is first allocated to outpatient services, ancillary services (by ancillary departments where the Departmental Method was used), and nonallowable cost centers, on the basis of the ratio of depreciation (direct expense to the department) claimed for each of these cost centers to the total depreciation claimed by the provider. The residual net depreciation adjustment not allocated to these centers is then allocated to each routine service cost center on the basis of the ratio of depreciation claimed for each routine cost center to total depreciation claimed for all routine cost centers.
- Step 2 - The adjustment to HI reimbursable cost for the net depreciation adjustment allocated to each cost center is determined based on the ratio of HI utilization to total utilization in the cost center, and utilizing the same basis for apportionment used in the provider's cost report, i.e., days and/or charges.

Schedule A demonstrates the process used to determine the adjustment to HI reimbursable cost based on a net depreciation adjustment in the amount of \$25,920 for the period ending 12/31/67.

132.4 (Cont.)

DEPRECIATION

<u>SCHEDULE A</u>	(1)	(2)	(3)	(4)	(5)
Period ending <u>12/31/67</u>	Depr. per <u>Cost Rpt</u>	% of Cost Ctr Depr. to <u>Tot Depr</u>	Allocation of Net Depr. Adjustment <u>.(Col. 2 X line 1)</u>	Percent HI Program Charges to Total Charges <u>(Per Cost Report Settlement Sheet)</u>	HI Adj. <u>(4 X 3)</u>
1. Net Depr. Adj.			\$25,920		
2. Total Depr. per Cost Report \$74,139					
3. Depart. Method Ancillaries Cost-Drugs Sold Physical Therapy					
4. Comb. Method Total Ancillaries	\$ 1,335	1.8%	\$ 467	42.3%	\$ 198
5. Nonallow. Cost Centers Beauty Shop	297	0.4%	<u>104</u>	0	
6. Net Depr. Adj. Subtotal			<u>\$ 571</u>		
		% of Routine Cost Center Depr. to Tot. <u>Routine Depr.</u>	Allocation of Routine Services (Col 2 <u>x line 10 below)</u>	% HI Utiliz. of Rout. Ser. <u>(Per CR)</u>	
7. Noncert. Routine Cost Center	\$23,283	39.7%	\$10,064	0	
8. Certified Routine Cost Center	<u>35,365</u>	<u>60.3%</u>	15,285	24.7%	<u>3,775</u>
9. Tot. Routine Depr. Cert. & Uncert. <u>\$58,648</u>		<u>100.0%</u>			
10. Net Depr. Adj. App. to Routine (line 1 - line 6)			<u>\$25,349</u>		
11. HI Adjustment					\$3,973
12. Allowance (See §132.3c)					<u>79</u>
13. Net Adjustment To HI Reimbursable Cost					\$4,052

tax purposes but still in use. Medicare will recognize for depreciation purposes an appropriate adjustment to the income tax valuation in the case of such assets where the correctness of the adjustment can be documented. The allowed valuation would be the cost of such assets as of the dates of acquisition less depreciation based on the expired portion of their useful lives as they may be revised for Medicare purposes.

Where minor equipment (§104.5) is concerned, the Medicare program recognizes that the inventory costs of such equipment may not truly reflect the cost of equipment purchased and in use by the provider. Differences in the capitalization policies of providers and their desire to limit property record controls over certain classes of small assets cause variations in the recorded costs of assets generally considered depreciable. Medicare then will recognize an appropriate adjustment to the inventory costs of these assets used by the provider for income tax purposes to acknowledge the additional assets included and will permit the depreciation or amortization of the remaining cost over the remaining useful lives of the assets.

However, where all other depreciable assets are concerned, such as buildings, building equipment, major movable equipment, land improvements, and leasehold improvements, Medicare will not recognize a historical cost of such assets in excess of the historical cost used for Federal income tax purposes. Providers should be able to support this historical cost by reference to original documents such as contracts, vouchers, checks, and other evidence. If the provider does not have such original documentation constituting primary evidence of the historical cost of assets, the intermediary will consider the provider's Federal income tax returns as secondary evidence to be used in establishing or verifying the historical cost of the assets. Further, it is possible that because of the effects of other provisions of the regulations, such as "Cost to Related Organizations," the historical cost under Medicare might be less than that allowed and used for Federal income tax purposes.

Under the regulations, providers may change the useful lives of assets where this can be justified and appropriately adjust the accumulated depreciation applicable to the historical cost of the assets involved. The effect of such adjustments is to change the undepreciated amount of the historical cost for Medicare purposes. The regulations do not permit providers to increase the historical cost basis of their assets to recognize elements of costs or expenditures which were not capitalized but were considered as expense items. For example, if a provider determined that a physical modification of the building was a repair and thus an item of expense not capitalized and uses the historical cost so determined for Federal income tax purposes, the provider may not change the historical cost basis to include that expenditure previously determined a repair and capitalize it; i.e., increase the historical cost basis of the building for Medicare purposes. As another example, if a provider builds a facility and in establishing the historical cost of the building determines that materials and labor used were not part of the historical cost of the building and charges the cost of such materials and labor into expenses for Federal income tax purposes, the provider may not then include such expenditures in the historical cost of the building for Medicare purposes.

These guidelines are to be applied retroactively as well as prospectively. Where an intermediary has approved an appraisal resulting in the establishment of asset costs in excess of the cost basis used for Federal income tax purposes, or where a proprietary provider has increased the historical cost basis of its assets to an amount in excess of the historical cost basis used for Federal income tax purposes by reference to supporting documentation, the intermediary will require a redetermination of historical costs. Costs in excess of the cost basis used for Federal income tax purposes will not be recognized under Medicare. Further, for cost reporting periods beginning on or after January 1, 1970, the intermediary will also require a redetermination of allowable costs for the reporting period covered to reflect the effects of the adjustment in the historical cost basis of the assets. For cost reporting periods beginning before January 1, 1970, however, no redetermination of such allowable costs need be made for the reporting periods covered. Accumulated depreciation applicable to the depreciable assets under the program will include the full amount allowed during those periods in which an increased historical cost basis was used. The net book value so established shall be used for computations of equity capital and determinations of gain or loss on the sale of assets and for any other reimbursement purposes under Medicare.

134.4 Fixed Assets Included in Appraised Values.--Fixed asset values established by an appraisal must include all provider-owned plant assets used in patient care or in the overall operation and administration of the institution. Fixed assets used in research and other nonallowable cost areas or functions should be included so that depreciation is reflected in those departmental costs to provide a proper basis for allocating administrative and general expense. Fixed assets of a related organization not used by a provider in rendering patient care, assets acquired in anticipation of expansion, and assets held for investment and not used in the plant operation should not be included as a part of the appraised values.

Generally accepted accounting principles relating to improvements or betterments must be followed in determining the asset valuation established by the appraisal. Repair or maintenance of a nature that restores an asset to its original condition but does not extend its useful life is not a betterment or improvement but an expense of that period.

134.5 Pricing Sources.--

A. Prime or Basic Source.--The pricing of assets to establish historical costs will be based on such actual supporting documents as vendor invoices and construction contractor completion statements. In the absence of invoices such other records as revenue stamps, board minutes, contracts of purchase and deeds recorded with the county's Recorder of Deeds may be used.

B. Other Sources and Techniques.--Other methods, such as manufacturer's catalogs, libraries of material prices, or techniques involving reverse trending and price indexes may be used to establish acquisition costs and acquisition dates. Such methods may be used only when actual supporting documents are not available. When these sources and techniques are used, consideration must be given to *manufacturers* and quantity discounts. The values arrived at should closely approximate the actual historical cost of an asset at the date of acquisition.

136.7 Allowance in Lieu of Specific Recognition of Other Costs and Return on equity Capital.--The recovery of the amount paid in excess of straight-line depreciation has an effect on the allowance in lieu of specific recognition of other costs--reimbursable for services provided through June 30, 1969 (see §136.10), and the return on equity capital (see §136.11).

136.8 Basis of Assets Following Recovery of Amounts Paid in Excess of Straight-Line Depreciation.--A recovery of the amount paid in excess of straight-line depreciation due to a decrease in health insurance utilization results in an increase in the book value of those assets for which accelerated depreciation had been claimed. This increase in book value is equal to the depreciation claimed by the provider in excess of straight-line depreciation. The depreciable basis of these assets, therefore, is increased beginning with the reporting period following the recovery period, to the extent of the depreciation recovered in excess of straight-line depreciation allowed to the provider.

After a recovery of depreciation in excess of straight-line depreciation, a provider may continue to use the same method of accelerated depreciation. Allowable depreciation after the recover period is based upon the adjusted book value of the asset and is allocated over the remaining life of the asset.

136.10 Effect of Recovery of Amounts Paid in excess of Straight-Line Depreciation on the Allowance in Lieu of Specific Recognition of Other Costs.--For each cost reporting period where depreciation paid in excess of straight-line depreciation has been recovered under *§136ff*, the provider's allowable cost for each of those periods is decreased by that amount. Therefore, the provider's allowance in lieu of specific recognition of other costs (applicable to services provided through June 30, 1969) is adjusted.

The amount recovered as a result of this adjustment is computed by applying the appropriate rate for the allowance in lieu of specific recognition of other costs (12 percent for proprietary providers or 2 percent for non-profit providers) to the HI adjustment for recovery of excess depreciation.

For cost reporting periods beginning before July 1, 1969, and ending after June 30, 1969, the full allowance should be calculated and the sum so obtained shall be apportioned to that part of the period before July 1, 1969, by applying to that sum a fraction consisting of a numerator which is the number of months before July 1969 and a denominator which is the number of months in the cost reporting period. Thus, if a provider's 12-month reporting year ended December 31, 1969, the allowance recovered would be $6/12 \times$ the allowance that would have been paid for the full 12-month period.

136.11 Computation of Increase in Equity Capital.--For proprietary institutions, the adjustment of accelerated depreciation to straight-line depreciation for a cost reporting period results in an increase in the provider's equity capital for each period in which accelerated depreciation is adjusted to straight-line depreciation is equal to the increase in the book value of the asset(s) as a result of the adjustment, less the additional reimbursement received by the provider as a result of claiming accelerated depreciation and the allowance in lieu of specific recognition of other costs. Also, the payments of the return on equity capital resulting from the conversion of accelerated depreciation to straight-line, increase the equity capital for subsequent cost reporting periods. (See example in §136.15A.)

136.13 Computation of Average Equity Capital Due to Adjustment From Accelerated Depreciation to Straight-Line Depreciation.--Section 136.11 explains the computation of the increase in equity capital due to the adjustment of accelerated depreciation to straight-line depreciation. Reimbursement to providers for the allowance of a reasonable return on equity capital, however, is based on the average equity capital during each reporting period. This section illustrates the computation of the estimated average equity capital as a result of the adjustment to straight-line depreciation.

The average equity capital for the earliest period for which recovery is made is one-half of the increase in equity capital for the period under the provisions of §136.11. The average equity capital for each period following the earliest period is one-half of the increase in equity capital for each prior period. This computation of average equity capital is illustrated in §136.15A.

For a reporting period during which the provider had previously had a zero equity balance at the end of an month, the average equity capital adjustment for the period is decreased by the percentage that the number of months in the period showing a zero balance bears to the total months in the period. (See illustration in §136.15B.)

(As an alternative to the procedures described in this section, a provider whose return on equity capital is adjusted may compute the adjustment to average equity capital for each cost period affected under the month-by-month calculation. *described in §1220.*)

136.14 Computation of Return on Equity Capital.--The return on equity capital for each period is computed by applying the rate of return and the ration that the program's share of allowable health insurance cost bears to total costs to the increase in average equity capital. This computation is illustrated in the example in §136.15A.