

**PROVIDER REIMBURSEMENT REVIEW BOARD  
HEARING DECISION**

ON-THE-RECORD  
98-D72

**PROVIDER -**  
St. Edward Mercy Medical Center  
Fort Smith, Arkansas

**DATE OF HEARING-**  
June 11, 1998

Provider No.           04-0062

Cost Reporting Period Ended -  
June 30, 1987

**vs.**

**INTERMEDIARY -**  
Blue Cross and Blue Shield Association/  
Blue Cross and Blue Shield of Arkansas

**CASE NO.**   90-1070

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ISSUES:

1. Were the Intermediary's adjustments to record rent expense for lease equipment as administrative and general costs, rather than capital-related costs, proper?
2. Was the Intermediary's adjustment denying treatment of costs relating to the installation of the Hospital Information System as start-up costs proper?

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

Saint Edward Mercy Medical Center ("Provider") is an acute care hospital located in Fort Smith, Arkansas. It filed its Medicare cost report for the fiscal year ended June 30, 1987 ("FY 87") claiming the disputed costs as allowable Medicare costs. Blue Cross and Blue Shield of Arkansas ("Intermediary") issued a Notice of Program Reimbursement disallowing the disputed claimed costs. The Provider appealed those adjustments to the Provider Reimbursement Review Board ("Board"). The appeal meets the jurisdictional requirements of 42 C.F.R. §§ 405.1835-.1841. The total amount in controversy is approximately \$180,000.

Issue No. 1 -- Rent ExpenseFacts

In March of 1986 the Provider entered into an agreement<sup>1</sup> with the Baptist Medical System ("BMS") whereby BMS furnished shared information services<sup>2</sup> to the Provider. Included in this service agreement is a provision<sup>3</sup> that BMS is to lease certain items of equipment to the Provider. The Provider recorded the lease cost of the equipment as a capital lease<sup>4</sup> and claimed depreciation and interest on its Medicare Cost Report.

The following are pertinent portions of the contract. The terms of the agreement at section 3.1 require BMS to maintain insurance covering the equipment and to pay any applicable taxes on the equipment. Section 17.7 of the agreement states that BMS shall take possession of the equipment upon termination of the agreement. Sections 22.1 and 22.2 require BMS to be responsible for maintenance on equipment provided by BMS.

The Provider recorded the portion of the "service" agreement between the Provider and BMS

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<sup>1</sup> See Intermediary Exhibit No. 1.

<sup>2</sup> See 2.2 of the agreement in Intermediary Exhibit No. 1.

<sup>3</sup> See 3.1 and Schedule D of the agreement in Intermediary Exhibit No. 1.

<sup>4</sup> See Intemediary Exhibit No. 2.

in its records as: (1) a capital lease of \$694,772 and (2) depreciation (\$269,772) and interest expense (\$76,602) for the current years claimed costs.<sup>5</sup>

The Intermediary reviewed the payments made by the Provider as billed by BMS for the agreement and imposed adjustment No. 111 to reduce the cost claimed by the Provider for equipment to the amount of rent paid for the equipment. It limited the costs to \$142,906 based on its analysis of “lease” payments paid to BMS.<sup>6</sup> That resulted in a reduction in Medicare reimbursement of approximately \$90,000.

#### PROVIDER’S CONTENTIONS:

The Provider contends that its initially filed cost report included \$203,423 of lease expense associated with information system lease. These costs are capital related costs as defined in Provider Reimbursement Manual, HCFA Pub. 15-1 (“HCFA Pub. 15-1”) § 2806.1 C. Under that section lease and rental payments, including license and royalty fees for the use of assets, are includable in capital related costs. The fact that the lease or rental is for a depreciable asset is sufficient for consideration as a capital related item. However, the lease or rental must convey the use, possession and enjoyment of the asset. The Provider contends that the agreement and possession of assets acquired through the lease supports the Provider's position. Therefore, the Provider requests that cost relating to the lease agreement be allowed and reimbursement by the Medicare Program as capital related costs.

The Provider contends that the lease is a capital lease under Financial Accounting Standards Board (“FASB”) Statement No. 13. Under that statement if a particular lease meets any one of the following classifications criteria, it is a capital lease:

- a. The lease transfers ownership of the property to the lessee by the end of the lease term.

Attachment 3, Hospital Information Services Agreement, does not transfer ownership of the property at the end of the lease.

- b. The lease contains an option to purchase the leased property at a bargain price.

There is discussion of purchase of the property at the end of the term. Due to the time necessary to hear this case, history has allowed the Provider time to document the purchase of this property at a discounted price.

- c. The lease term is equal to or greater than 75% of the estimated economic life of the leased property.

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<sup>5</sup> See Intermediary Exhibit No. 2.

<sup>6</sup> See Intermediary Exhibit No. 3.

The AHA guidelines for useful life allows 3 years for CRT and 5 years for computers and computer related equipment.

- d. The present value of rental and other minimum lease payments equals or exceeds 90 percent of the fair value of the leased property.

The lease payments were established in a market environment. No formal appraisal was performed to document the fair market value of the lease property at the inception of the lease. The Provider believed this documentation would not be necessary.

FASB Statement No. 13 requires that only one of the four criteria be met for a lease to qualify as a capital lease. Requirements set forth in criteria two and three have both been established by documentation presented in the Hospital Information Service Agreement as well as additional documentation in the record.

The Provider uses the Medicare regulations and Generally Accepted Accounting Principles (“GAAP”) to prove the proper treatment. Logically, the Medicare Program would have reimbursed the equipment cost to BMS had BMS bought the equipment for their own use. However, BMS removed this cost from its Medicare cost report in order for the Provider to properly claim this ownership cost on its cost report. In addition, had the chosen vendor been a computer vendor rather than another hospital, the Provider believes that there would be no disputing the proper treatment of the relevant costs.

The Provider questions whether the costs of the equipment capital related or operating expenses. The Provider’s position is that Medicare regulations were followed as presented in the Service Agreement Section 3.3, and the GAAP requirements of FASB Statement No. 13 have been met. Therefore, the lease should be treated as a capital lease and the costs reimbursed by the Program as capital related costs.

#### INTERMEDIARY’S CONTENTIONS:

The Intermediary contends that based upon sections 3.1, 17.7, 22.1, and 22.2 of the Agreement, the Provider does not own or have title to the equipment leased to it by BMS. Since the Provider does not own the equipment, it cannot claim ownership costs for Medicare reimbursement as it has done by reporting imputed costs calculated as directed by GAAP, i.e., reporting the leasehold costs as a capital lease is essentially equivalent to reporting them as ownership costs. Since the Provider is not the owner of the assets, the only costs the Provider can claim are the costs it incurred which were the rent payments.

The Intermediary notes that § 1861(v)(1)(A) of the Social Security Act requires providers of services to Medicare beneficiaries to be reimbursed the reasonable cost of those services. Reasonable cost is defined as the cost actually incurred, excluding therefrom any part of incurred cost found to be unnecessary in the efficient delivery of needed health services, and

shall be determined in accordance with regulations establishing the method or methods to be used. The principles of the law are reiterated at Medicare regulation 42 C.F.R. § 413.9. In this case the cost the Provider incurred to obtain the use of the equipment is the rent payments for which it was liable.

## Issue No. 2 -- Operating Costs

### Facts

The Provider capitalized \$200,000 of start-up costs to implement the computerization of the Provider by BBS. The activities were: (1) installation of equipment, (2) establish communications network, (3) on-site training, and (4) systems generation costs which prepared the Provider for operating the computer system.

The Provider incurred \$106,500 of these start-up costs in FY 86 and \$93,500 in FY 87. The Provider claimed these costs as start-up capital costs. The Intermediary considered these costs as start-up operating costs under HCFA Pub. 15-1 § 2132. As such, it allowed amortization of the start-up operating costs over 60 months. For the FY 86 costs (\$106,500), it allowed an amortized cost of \$21,300 in FY 87.<sup>7</sup> For the FY 87 start-up costs incurred (\$93,500), it allowed \$18,640.<sup>8</sup> The costs were treated as general and administrative expenses.<sup>9</sup> The overall effect of the Intermediary's treatment results in a reduction in Medicare reimbursement of approximately \$90,000.

### PROVIDER'S CONTENTIONS:

The Provider contends that the issue stated concerns costs incurred in the initial preparation of its information system. The Intermediary's adjustment removes \$200,000 paid by the Provider to the information system vendor. The Provider contends that these costs meet the definition outlined in HCFA Pub. 15-1 § 2132, relating to start-up costs, and should be reimbursed accordingly.

That section states in part:

Start-up costs are incurred from the time preparation begins on a newly constructed . . . where start-up costs apply only to nonrevenue-producing patient care functions or nonallowable functions, to the time the areas are used

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<sup>7</sup> See Intermediary Exhibit 3 (Adjustment No. 113).

<sup>8</sup> See Intermediary Exhibit 3 (Adjustment No. 112).

<sup>9</sup> Since the Provider was under Medicare's Prospective Payment System, all costs were effectively denied by the Intermediary.

for their intended purposes.” “. . . Start-up costs should be capitalized and amortized separately.

Id.

The Provider requests Medicare Program reimbursement of capital related costs associated with start-up expenses incurred during implementation of the hospital's information system.

INTERMEDIARY’S CONTENTIONS:

The Intermediary contends that the Medicare regulation at 42 C.F.R. § 413.130 defines the costs which can be included as capital costs. Costs of training the Provider's employees to use equipment leased from BMS and costs of software developed and owned by BMS and costs of personnel at BMS who manage computer equipment and are responsible for computer operations do not qualify under the regulation to be claimed as capital costs by the Provider.

The Intermediary observes that the training costs that it reclassified as administrative costs are costs of training the Provider's employees to use the BMS shared information system. It is not a capital cost to train the Provider's employees to use equipment leased to the Provider. It is not a cost of acquiring the equipment or preparing it for use. Further, the system generation costs classified by the Intermediary as administrative costs are costs to develop software programs which remain the property of BMS and are set up to handle the Provider's data. These are not costs of acquiring any assets of the Provider. Therefore, the costs classified as operating by the Intermediary are not costs incurred by the Provider to acquire assets located on its premises. They do not qualify as capital under the definition of capital costs.

CITATION OF LAW, REGULATIONS AND PROGRAM INSTRUCTIONS:

1. Law - Title XVIII of the Social Security Act:

§ 1861 (v)(1)(A) - Reasonable Cost

2. Regulations - 42 C.F.R.:

§§ 405.1835-.1841 - Board Jurisdiction

§ 413.9 - Cost Related to Patient Care

§ 413.130 - Introduction to Capital-Related Costs

3. Program Instructions - Provider Reimbursement Manual, Part I, HCFA Pub. 15-1:

§ 104.10	-	Historical Costs
§ 2132	-	Start-Up Costs
§ 2806.1C	-	Costs Included in Capital-Related Costs

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DISCUSSION:

The Board, after considering the law, regulations, program instructions, facts and parties' contentions, finds and concludes as follows:

Issue No. 1 -- Rent Expense

The Board finds and agrees with the Provider's contention that the portion of service agreement relating to capital assets is a capital lease under GAAP. As such, the Provider properly included "ownership" costs, i.e., the amortization of the capital lease (called depreciation by the Provider) and related interest expense, as an allowable Medicare cost. The lease is a capital lease because it meets condition B of FASB No. 13, the controlling GAAP rule. The service agreement specifically addresses reduced costs to purchase the leased equipment upon termination of the contract. In fact, the Provider did actually purchase the property at a discounted value (\$160,587) in January, 1992.

The Board does not agree with the amount of depreciation and interest claimed by the Provider under this "virtual purchase" arrangement. The Intermediary in its Exhibit I-3 did a complete analysis of the service agreement payments for FY 87. This resulted in only \$142,926 for payments related to the capital asset lease. Assuming that the overall costs of all components of the service agreement are reasonable, the Board concludes that the above payment for capital assets is likewise reasonable. Therefore, payments for capital assets would be limited to "reasonable" costs under 42 C.F.R. § 413.9. It is noted that the Provider never contested the capital cost component calculation of the service agreement. Further, the Provider never explained nor provided documentation as to how it arrived at FY 87 "depreciation" and interest expense claimed. Based on all of the above, the Board limits the capital lease payments to reasonable costs (\$142,926) incurred under 42 C.F.R. § 413.9.

Issue No. 2 -- Operating Costs

The Board finds that the \$200,000 incurred by the Provider to implement the Provider's computer system is a capital-related cost that should be included as part of the historical cost of the capital lease. Installing equipment, establishing the communications network, on-site training and system general are all activities related to a capital project and are capitalized as

such. HCFA Pub. 15-1 § 104.10 defines historical cost as including the cost of preparing an asset for use. It further states that such costs include costs that would be capitalized under GAAP.

The above activities performed by BMS for the Provider meet this definition and should, therefore, be capitalized. The Board notes that the Provider argues that these costs are allowable capital start-up costs under HCFA Pub. 15-1 § 2132. The Intermediary argues that these costs are operating costs under the same section. The Board, however, finds that these costs are not covered by this section. They should be added to the present value of the capitalized lease payments, i.e., the de facto historical costs of the assets and depreciated over the useful lives of the assets.

#### DECISION AND ORDER:

##### Issue No. 1 -- Rent Expense

The portion of the service agreement relating to the lease of equipment is a capital lease under GAAP. However, payments are limited to actual costs as calculated by the Intermediary based on 42 C.F.R. § 413.9. The Intermediary's adjustments are affirmed.

##### Issue No. 2 -- Operating Costs

The \$200,000 payment by the Provider to BMS to implement the computer system is an allowable capital cost amortized over the useful life of capital lease. The Intermediary's adjustments are reversed.

##### Board Members Participating:

Irvin W. Kues  
James G. Sleep  
Henry C. Wessman, Esquire

Date of Decision: July 02, 1998

##### FOR THE BOARD:

Irvin W. Kues  
Chairman