PROVIDER REIMBURSEMENT REVIEW BOARD HEARING DECISION

2000-D36

PROVIDER - Alacare Home Health Services, Inc.

Provider No. 01-7009

vs.

INTERMEDIARY -Blue Cross and Blue Shield Association/Palmetto Government Benefits Administrators

DATE OF HEARING- September 24, 1998

Cost Reporting Period Ended - December 31, 1994

CASE NO. 97-0795

INDEX

ISSUE:

Was the Intermediary's adjustment calculation proper to bring the expenses of Healthstar Inc, a related party, to the cost of ownership?

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:
FACTS:

Alacare Home Health Services, Inc. ("Provider") is located in Birmingham, Alabama and has participated in the Medicare program as a certified home health agency since January 1, 1987.

The Provider established Healthstar, Inc. ("HS"), a related party, for the purpose of purchasing medical and other supplies in quantity to obtain lower costs via discounts; and to re-sell these supplies to various other Alabama home health agencies. Since HS is a related party, the Intermediary reduced the charges of the Provider's purchases of medical supplies from HS to the "cost of the related organization" pursuant to the Medicare regulation at 42 C.F.R. § 413.17, Cost to related organizations.

In determining HS's cost of supplies, $21,701 of its accounts receivables ("AR") pertaining to other entities were deemed uncollectible and was included as a bad debt cost. The Medicare regulations at 42 C.F.R. § 413.80 defines a "Bad Debt" as a "deduction from revenue not to be included in Medicare reimbursable cost."

Since HS could not specifically identify the precise cost of the supplies sold to the Provider [or other buyers], the Intermediary used HS's financial statements to calculate the approximate cost of the supplies sold. The Intermediary's computation consisted of determining HS's: 1) total income, 2) income from the Provider, 3) the percentage ("%") of HS's revenue applicable to the Provider, 4) profit margin; and then multiplying the profit margin by the income from the Provider to determine the cost of the supplies. Before making the above computations, the Intermediary made an adjustment eliminating HS's bad debt cost attributable to the sales from other unrelated parties.

The dispute in this case focuses upon the treatment of HS's bad debt cost. The Provider claims HS determined $21,701 of its AR were uncollectible and properly includable as a cost. Using the "direct write-off" method, HS created a "Bad Debt Expense" ("BDE") account and reduced its AR while

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[1] Accounting Journal Entries used by HS:

1. Sales made on credit:
   Accounts receivable (AR)

2. AR determined worthless:
   Bad Debt Expense

including the BDE as a cost which increased the cost of supplies and reduced the net profit (and the related gross profit margin).

Conversely, in calculating HS's "cost of the supplies," the Intermediary reversed the HS's BDE accounting treatment because Medicare declares bad debts as a non-allowable cost except for related beneficiary deductibles and co-insurance which were not applicable in this case. Thus, HS's total costs were reduced by the amount of BDE yielding a lower cost of the supplies and a higher net profit.

The Provider disagreed asserting there was a "double" adjustment by the removal of BDE from HS's total expense and a distortion of costs.

The Parties' made the following stipulation of facts:

1. Healthstar, Inc. was a Special Purpose organization founded to purchase Medical and other supplies at a discount and re-sell these to various Alabama Home Health Agencies.

2. Healthstar, Inc. is considered a "Related Party" to the Provider for the period at issue.

3. For the period in question, $21,700.99 in Receivables were deemed uncollectible by the supplier and written off the books; Revenues were reduced through inclusion of a "Bad Debt Expense" for this amount.

4. During the audit of Provider's 1994 Cost Report, Intermediary adjusted Provider's supply purchases to cost in accordance with PRM §1000. The adjustment was computed as a percentage of Healthstar's Net Income.

5. The Intermediary increased Healthstar's Net Income (utilized for the adjustment computation) through an add back of the above noted $21,700.99 in uncollectible accounts (Bad Debts). PRM §1005 was cited as support for the need to a adjust supplier expense to what would be allowable under Medicare. PRM §413.80 was cited as support for the need to consider the A/R write off (classified as Bad Debts) as non-allowable for a Medicare provider and thus inappropriate for the computation.

6. The reimbursement effect of this adjustment is approximately $10,079.21 to the Provider.

AR

[2] The Intermediary cited HCFA Pub. 15-1 §1005 as the basis of the adjustment and for reversing the Provider's accounting treatment.

7. Provider' s 1993 supply expense relating to purchases from Healthstar was adjusted to cost by the Intermediary using a percentage of Net Income. The Provider self adjusted Healthstar expense to cost for FYE 12/31/95 using a percentage of Net Income.

8. The following corrected Income Statement amounts have been agreed upon for the period of 1/91 through 12/94:

Healthstar Gross Income	-	$950,809
Alacare payments to Healthstar	-	$651,136
Percentage Healthstar Revenue from Aiacare	68%	
Healthstar Net Income (including write off)		$24,840.58

The Intermediary issued a final Notice of Program Reimbursement ("NPR") for FY 1994 that included an adjustment of $33,074 to reduce the Provider's claimed medical supply costs to the cost of ownership by HS. This adjustment was calculated as follows:

HS's profit margin		$49,509
PLUS: Non-allowable BDE		21,701
Adjusted Profit Margin	$71,210	
Provider's % of HS's Revenue		46.45%
Cost of Ownership Adjustment		$33,074

The estimated Medicare reimbursement effect of the disputed adjustment is about $10,079.

The Provider disputed the Intermediary's NPR concerning the adjustment determining the "cost of the supplies" by HS, and filed a timely hearing request to the Provider Reimbursement Review Board ("Board") and has met the jurisdiction requirements of 42 C.F.R. § 405.1801 et seq. particularly §§ 405.1835-1841. A telephone hearing was held on September 24, 1998. Other issues originally appealed have either been administratively resolved or withdrawn.

The Provider was represented by Paul E. Auffant, of Alacare. The Intermediary was represented by James R. Grimes, Esquire of the Blue Cross and Shield Association.

Medicare Statutory and Regulatory Background**:**

The Medicare law established that health care providers furnishing services to Medicare patients were to be reimbursed the reasonable cost ("RC") of providing such services. Title XVIII of the Social Security Act, section 1861, codified at 42 U.S.C. § 1395x(v)(1)(A), defines RC as "the costs actually incurred, excluding therefrom any part of incurred costs 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, and the items to be included...." Id. This statutory provision also sets forth the provision that Medicare shall not pay for costs incurred by non-Medicare beneficiaries, and vice-versa, i.e., Medicare prohibits cross-subsidization of costs.

Congress authorized the Secretary of Health and Human Services ("Secretary") to promulgate regulations to implement the RC statutory provision. The foregoing principles are further explained in the Medicare regulations in part at 42 C.F.R. § 413.17 et seq.

The Medicare "Cost to Related Organizations" regulation states:

(a) Principle. Except as provided in paragraph (d) of this section, costs applicable to services, facilities, and supplies furnished to the provider by organizations related to the provider by common ownership or control are includable in the allowable cost of the provider at the cost to the related organization. However, such cost must not exceed the price of comparable services, facilities, or supplies that could be purchased elsewhere.

(b) Definitions. (1) Related to the provider. Related to the provider means that the provider to a significant extent is associated or affiliated with or has control of or is controlled by the organization furnishing the services, facilities, or supplies.

(2) Common ownership. Common ownership exists if an individual or individuals possesses significant ownership or equity in the provider and the institution or organization serving the provider.

(3) Control exists if an individual or an organization has the power directly or indirectly, significantly to influence or direct the actions or policies of an organization or institution.

42 C.F.R. §413.17 et seq. (emphasis added).

The Medicare "Bad Debts" regulation states:

(a) Principle. Bad debts ... are deductions from revenue and are not to be included in allowable cost; however, bad debts attributable to the deductibles and coinsurance amounts are reimbursable under the program.

* * * *

(e) Criteria for allowable bad debt. A bad debt must meet the following criteria to be allowable:

(1) The bad debt must be related to covered services and derived from deductible and coinsurance amounts.

(2) ... establish that reasonable collection efforts were made.

(3) The debt was actually uncollectible when claims as worthless.

(4) Sound business judgement established that there was no likelihood of recovery at any time in the future.

42 C.F.R. § 413.80(a) and (e) (emphasis added).

The Health Care Financing Administration ("HCFA") also publishes the Provider Reimbursement Manual, ("HCFA Pub. 15-1), that contains statements of policy and instructions which serve to explain the regulatory provisions.

The manual provisions for "Cost to Related Organizations" are found in Chapter 10 of HCFA Pub. 15-1 which state in part:

1000. PRINCIPLE.

> Costs applicable to services, facilities, and supplies furnished to the provider by organizations related to the provider by common ownership or control are includable in the allowable cost of the provider at the cost to the related organization. However, such cost must not exceed the price of comparable ... supplies that could be purchased elsewhere.

1005. DETERMINATION OF A RELATED ORGANIZATION'S COSTS

> The related organization's costs include all reasonable costs, direct and indirect, incurred in the furnishing of services, facilities, and supplies to the provider. The intent is to treat the costs incurred by the supplier as if they were incurred by the provider itself. Therefore, if a cost would be unallowable if incurred by the provider itself, it would be similarly unallowable to the related organization. The principles of reimbursement of provider costs described elsewhere in this manual will generally be followed in determining the reasonableness and allowability of the related organization's costs, except where application of a principle in a non-provider entity would be clearly inappropriate (e.g. Chapter 13, Inpatient Routine Nursing Salary Cost Differential; [and chapters: 22 through 26]).

HCFA Pub. 15-1 §§ 1000 and 1005 (emphasis added).

PROVIDER'S CONTENTIONS:

The Provider contends that the application of Medicare reimbursement regulations concerning HS's bad debts causes a material distortion of reimbursable costs of the Provider.

The Provider contends the Intermediary's computation of the "cost of ownership" was incorrect because the bad debt costs were added back to determine HS's cost of goods sold and gross profit margin.

The Provider argues the Medicare reimbursement principles should not be used in this instance because HS is a profit making entity; and this concept is supported by the Medicare reimbursement manual which states in part:

> The principles of reimbursement of provider costs described elsewhere in this manual will generally be followed in determining the reasonableness and allowability of the related organization's costs, except where application of a principle in a non-provider entity would be clearly inappropriate.

HCFA Pub. 15-1 § 1005 (emphasis added).

The Medicare bad debt regulation at 42 C.F.R. § 413.80 presents a completely different meaning and concept than a normal business enterprise and normal accounting treatment. The bad debt regulation pertains to "deductibles and co-insurance" for services billed to a Medicare patient. On the other hand, a business bad debt relates to an uncollectible sale which is a direct reduction of revenues and profit margin.

The Provider maintains that the bad debt costs for the production of the supplies associated with non-collectible HS revenues reduce the "profit" made on all items sold during the accounting period, including the supplies sold to the Provider. Re-introducing these uncollectible revenues artificially offsets the production costs by inflating the supply mark up.

The Provider asserts that the Provider and the Intermediary did not use this methodology in the immediate three year period to determine HS's cost of supplies furnished the Provider. The application of the bad debt regulation and the manual section 1005 represents a significant departure resulting in a material distortion of the reimbursable costs for this three year period.

HS's BDE represents a full write off to its AR, which clearly is dissimilar to how Bad Debts are defined and treated under the Medicare system.

The Provider asserts that Medicare regulation 42 C.F.R. § 413.80 requires that the "costs of covered services furnished to beneficiaries are not to be borne by individuals not covered by the Medicare program". Manually adjusting Healthstar's profit margin through addition of noncollectible revenues misstates the actual profit for the period, thereby understating the actual amount of Alacare's supply expense reimbursable by the program.

The Provider states the Medicare regulations and general accounting principles require the matching of costs for patient care activities with revenues in each accounting period. The Intermediary's adjustment distorts the costs for the year in dispute.

The Provider states that the write off of HS's AR as a BDE is directly relevant to the computation of the amount of "offsetable" profit made by the Related Party in 1994. The Provider requested in its position paper that the FY 1994 adjustment for HS's supply purchases be computed as follows:

Total Gross Income - Healthstar		$950,809
Non-collectible Portion [Bad Debt]		21,701
Net Revenues		$929,108
Provider payments to Healthstar		$651,136
Provider percentage of HS Revenue		68%
Healthstar	- COGS Expense	$834,476
	- Overhead Expense	70,881
Total Supply Production Costs		$905,357
Healthstar Net Income		$ 24,841
Adjustment to cost		$ 16,891
Intermediary adjustment		$ 33,074
Requested correction		$ 16,183

The Provider claims the Intermediary's adjustment may have an adverse duplication impact in the following FY, 1995.

INTERMEDIARY'S CONTENTIONS:

The Intermediary contends that it has properly determined HS's cost of ownership for the supplies sold to the Provider pursuant to the applicable Medicare regulations and authorities for related parties and cost reimbursement principles.

The Intermediary's contends that the bad debt expense associated with HS's AR is not an allowable cost since it would be nonallowable to the Provider as provided by 42 C.F.R. § 413.80 and HCFA Pub 15-1 §1005. Therefore, the BDE had to be eliminated as a cost in determining the profit and profit margin of HS's business with the Provider to determine the cost of ownership.

The Intermediary disagrees with the Provider's assertion that the exclusion of HS's BDE is inappropriate under the circumstances since it is a profit making organization. The related organization regulation at 42 C.F.R. § 413.17 requires the related party to be treated as if it was a Provider. The regulations also require that services or supplies furnished by a related party must be reduced to the cost of ownership. Thus, the Provider's contention that the Medicare regulations distorts HS's reported financial data is without merit.

The Intermediary recognizes that bad debts are defined and treated differently under the Medicare system than for tax purposes because it is a program with specific cost reimbursement principles which Providers basically accept as a participant thereof.

The Intermediary describes its adjustment as follows:

> Using HS's financial statements, the Intermediary determined HS's profit margin for 12/31/94 to be $49,509, then add back the bad debts of $21,701 for a revised profit margin of $71,210; and HS's percentage of business with the Provider was calculated to be 46.45% using total revenues of HS compared to total revenues related to the Provider. The profit margin of $71,210 was then multiplied by the 46.45% yielding $33,074 which is the amount to reduce costs associated with HS supply costs on the Provider's books. This calculation and adjustment resulted in bringing the costs originally claimed by the Provider in line with the cost to the related organization, HS.

The Intermediary illustrates the Profit Margin Method:

PROFIT MARGIN METHOD

HS's Total profit margin [per fin. stat.]	$49,509	
Add: Total non-allowable bad debts		21,701
Total revised Profit Margin		$71,210
		x
Percentage of HS's Revenues to Provider's		46.45
Profit Margin to reduce costs to ownership		$33,074
Total costs claimed by Provider		$651,136
Less: Profit Margin		- 31,649
Total allowable costs of Ownership		$619,487

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[3] Intermediary Exhibit I-10.

[4] Add here since BDE was included as a cost in determining profit margin.

In response to the Provider's claim that HS's total revenues and expenses must be used, the Intermediary asserts the same result is achieved if the "Total Expense Method" is used illustrated as follows:

TOTAL EXPENSE METHOD

HS's total expenses per Financial Statements	$1,353,530
Less: Non-allowable bad debts	- 21,701
Total HS allowable Expenses	$1,331,829
	x
Percentage of HS's Revenues to Provider's	46.45
Adjusted Allowable Cost	$ 618,580

Comparable Minimal Variance:	
Total Expense Method	$ 618,580
Profit Margin Method	618,063
Variance	$ 517

The Intermediary states the Provider's claim that there is a duplication of the offset of bad debts and that it will have an adverse impact the following year is without merit.

The Intermediary states there are no additional credits to revenue when bad debt expense is reversed. Therefore, there is no duplication of the lntermediary's disallowance of bad debts in fiscal year 12/31/94. The only way the related service revenue could have been recorded again in the subsequent year would be if HS improperly reversed their bad debt expense by crediting revenue. As the Provider has not given any evidence to support the error, the Intermediary stands by its initial determination.

With respect to the impact in FY 1995, the Intermediary asserts the documentation submitted by the Provider was unsatisfactory to ensure that HS actually credited revenue again to reverse the bad debt expense. The accounting described did not conform to accounting standards. Since HS uses the direct write off method to account for bad debt expense, the following journal entries should have been made to account for the entire bad debt situation:

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[5] Add here since BDE was included as a cost in determining profit margin

1) Earned the Revenue

Journal Entry:	Accounts Receivable (A/R)		xx
	Revenue	xx	

(2) Receivable Deemed Worthless

Journal Entry	Bad Debt Expense	xx	
	A/R		xx

(3) Received Payment for the Bad Debt

Journal Entries	A/R	xx
Retained Earnings		xx
Cash	xx	
A/R		xx

The Intermediary states that without documentation supporting the alleged claim that HS incorrectly stated total revenues in fiscal year ended 12/31/95, the Intermediary cannot accept the assertion that some sort of duplication occurred. Therefore, the adjustment to reduce HS's total cost to determine the allowable cost of the supplies furnished was appropriate and in accordance with Medicare regulations and instructions.

<u>CITATION OF LAW, REGULATIONS AND PROGRAM INSTRUCTIONS</u>:

1. <u>Law - 42 U.S.C.</u>:

§ 1395x(v)(1)(A) - Reasonable Cost

2. <u>Regulations - 42 C.F.R.</u>:

§ 405.1800 <u>et seq.</u> - Provider Reimbursement Determinations and Appeals

§ 405.1835 - 1841 - Board Jurisdiction

§ Part 413 et seq.	-	Principles of Reasonable Cost Reimbursement
§ 413.17 et seq.	-	Related Organizations
§ 413.20	-	Financial Data and Reports
§ 413.80 et seq.	-	Bad Debts, Charity, and Courtesy Allowances

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

§ 1000 et seq.	-	Cost to Related Organizations

FINDINGS OF FACT, CONCLUSION OF LAWS AND DISCUSSION:

The Board, after consideration of the facts, parties' contentions, evidence presented, testimony elicited at the hearing, and post-hearing briefs, finds and concludes that the Intermediary's adjustment determining the cost of the supplies furnished by a related party to the Provider was proper.

The Board finds that:

1. The parties stipulated the Provider and Healthstar, Inc. ("HS") were related parties.

2. The provisions of 42 C.F.R. § 413.17, cost to related organizations, becomes dispositive concerning the cost the Provider may claim for reimbursement of the supplies furnished by HS, a related party.

3. Pursuant to 42 C.F.R. § 413.17(a) and (c)(2), where supplies are furnished by a related party, the provider of services may only include as an allowable cost in its cost report the cost of such supplies to the related organization. This is because the regulation provides that the provider is essentially obtaining items from itself.

4. HCFA Pub. 15-1 § 1005 states in part that:

> The intent is to treat the costs incurred by the supplier as if they were incurred by the provider itself. Therefore, if a cost would be unallowable if incurred by the provider itself, it would be similarly unallowable to the related organization.

(Emphasis added.)

5. In determining the "cost of the supplies" furnished by HS, other Medicare regulations become applicable, such as 42 C.F.R. §§ 413.20, Financial data and reports, and 413.80, Bad debts.

6. Although HS included bad debts from other purchasers as an element of cost, Medicare does not include bad debts as a cost, except for beneficiary deductibles and co-insurance which are not applicable in this case.

The Board concludes that the Intermediary's adjustment properly eliminated HS's bad debts from its other customers in determining the cost of the supplies furnished to the Provider; and the adjustment was in accordance with Medicare reimbursement regulations, policies, and instructions. 42 C.F.R. § 413.17 clearly requires a determination of HS's cost of the supplies furnished to the Provider so that such costs could be properly included in the Provider's cost report for the supplies furnished by HS. In addition, such cost could not include the bad debt cost from other unrelated outside customers of HS pursuant to 42 C.F.R. § 413.80. Moreover, the Medicare statute and regulations provide that the "costs of covered services furnished to beneficiaries are not to be borne by individuals not covered by the Medicare program, and vice versa." Hence, in this case, the Intermediary's adjustment ensures that the Medicare program will not bear the cost of bad debts attributable to business entities unrelated to the patient care activities of this Provider.

The Board concludes and rejects the Provider's argument that it is inappropriate to apply the Medicare reimbursement principles in this particular instance because HS is a profit making entity. The Board acknowledges that although HCFA Pub. § 1005 indicates the "inappropriate" concept as a possible exception, it must be clearly demonstrated. The Board finds and concludes the Provider's bare allegation of a "profit making entity" is not inherently justifiable; and the Provider did not submit any other supporting evidence of demonstrating why it was "clearly inappropriate" to invoke the exception.

The regulation at 42 C.F.R. § 413.17 clearly requires the related party entity to be treated as if it was the provider for reimbursement purposes.

The Board rejects the Provider's claim that the parties non use of this methodology in prior years to determine HS's cost of supplies furnished the Provider should preclude its use now; and that it will cause a significant distortion in cost now and in the future. The Board finds and concludes that the methodology in prior years is immaterial particularly since there was no evidence submitted showing any adverse impact or the claimed distortion of costs currently or in future years. Thus, the Board finds the claim is without merit.

In addition, the assertion that the Medicare regulations distorts HS's current reported financial data is without merit.

DECISION AND ORDER:

The Intermediary's adjustment properly eliminated the related party's bad debt cost from outside customers when determining the cost of the supplies furnished by the related party to the Provider. The Intermediary's adjustment is affirmed.

Board Members Participating:

Irvin W. Kues
Henry C. Wessman, Esq.
Martin W. Hoover, Jr., Esq.
Charles R. Barker
Stanley J. Sokolove

Date of Decision: March 24, 2000

FOR THE BOARD

Irvin W. Kues
Chairman