

# PROVIDER REIMBURSEMENT REVIEW BOARD DECISION

2008-D16

**PROVIDER -**  
Hillcrest Baptist Medical Center  
Waco, Texas

Provider No.: 45-0101

vs.

**INTERMEDIARY -**  
BlueCross BlueShield Association/  
TrailBlazer Health Enterprises, LLC

**DATE OF HEARING -**  
September 2, 2004

Cost Reporting Period Ended -  
August 31, 1986

**CASE NO.:** 89-1584

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ISSUES:

1. Whether capitalized interest that may have been amortized in future years can be expensed in the current year when future cost reports are no longer subject to reopening.
2. Whether the Intermediary's determination of allowable interest expense which deducted Hillcrest Medical Tower (HMT) interest from allowable versus total expense is proper.
3. Whether the Intermediary's adjustment to disallow accrued FICA expense is proper.
4. Whether the Intermediary's adjustment to the cafeteria revenue offset is proper.
5. Whether the Intermediary's adjustment to limit bond cost amortization is proper.
6. Whether the Intermediary's adjustment to disallow debt cancellation costs is proper.
7. Whether the Intermediary's adjustment to disallow depreciation expense is proper.
8. Whether the Intermediary's determination that a portion of the 1985 bonds were unnecessary is proper.
9. Whether the Intermediary's adjustment to disallow accrued zero coupon bond interest expense is proper.

MEDICARE STATUTORY AND REGULATORY BACKGROUND:

This is a dispute over the amount of Medicare reimbursement due a provider of medical services.

The Medicare program was established to provide health insurance to the aged and disabled. 42 U.S.C. §§1395-1395cc. The Centers for Medicare and Medicaid Services (CMS), formerly the Health Care Financing Administration (HCFA), is the operating component of the Department of Health and Human Services (DHHS) charged with administering the Medicare program. CMS' payment and audit functions under the Medicare program are contracted out to insurance companies known as fiscal intermediaries. Fiscal intermediaries determine payment amounts due the providers under Medicare law and under interpretive guidelines published by CMS. See, 42 U.S.C. §1395h, 42 C.F.R. §§413.20(b) and 413.24(b).

At the close of its fiscal year, a provider must submit a cost report to the fiscal intermediary showing the costs it incurred during the fiscal year and the portion of those costs to be allocated to Medicare. 42 C.F.R. §413.20. The fiscal intermediary reviews the cost report, determines the total amount of Medicare reimbursement due the provider and issues the provider a Notice of Program Reimbursement (NPR). 42 C.F.R. §405.1803. A provider dissatisfied with the intermediary's final determination of total reimbursement may file an appeal with the Provider Reimbursement Review Board (Board) within 180 days of the issuance of the NPR. 42 U.S.C. §1395oo(a); 42 C.F.R. §405.1835.

The Board originally issued Decision No. 2005 D-50 dated August 11, 2005. On August 26, 2005, the Provider requested a reconsideration of this decision and a remand for the Board to consider issues omitted from the 2005 decision. The Board reviewed the Provider's request and vacated the above decision on August 29, 2005. The current decision replaces Board Decision No. 2005-D50.

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

Hillcrest Baptist Medical Center (Provider) is a general short-term hospital located in Waco, Texas. The Provider appealed the Intermediary's determination to the Board and met the jurisdictional requirements of 42 C.F.R. §§405.1835 – 405.1841. The Provider was represented by Lance S. Loria, C.P.A., of Loria Associates, Inc. The Intermediary was represented by James R. Grimes, Esquire, of Blue Cross Blue Shield Association.

Issue No. 1: Renovation Interest – Current Expense v. Capitalized

The Provider renovated its hospital and built a medical office building. During the fiscal years in issue, Medicare shared in the Provider's capital costs by reimbursing its share of depreciation, interest and other related capital costs. This issue involves how those capital expenses are accounted for in the cost report.

The parties stipulated to the following material facts:

1. The Series 1984 bond proceeds funded the construction project in the amount of \$22,105,000, including the following items:
 

• New Construction	\$11,676,000
• Equipment	3,266,000
• Professional Fees	1,340,000
• Renovation Costs	4,617,000
• Contingency	<u>1,206,000</u>
• Total	\$22,105,000
  
2. The parties agree to the construction – in – progress (CIP) schedule of completion amounts and timing, as set forth in Provider Exhibit P-60 and the calculation of the 43.5% expense ratio before considering renovations.

3. The parties acknowledge that the use of estimated percentages of completion for the financial statements and related disclosure (footnote 6) is in accordance with GAAP FASB 34 (see Provider Exhibit P-24) [sic]<sup>1</sup> since the differences would not have a material impact on the audited financial statements. In addition, the parties agree that Medicare has not adopted FASB 34, and Medicare requires that the actual capitalization percentages be used in determining the interest cost to be expensed and capitalized in the cost report.
4. The parties agree with the total renovations amount of \$4,729,569 and the methodology used in the determination of the interest expense ratio of renovations which yielded an additional expense ratio of 29.0% as set forth in Section 3.5-2 and Table 3 of the Provider's Final Position Paper. This results in a final expense ratio of 72.5% (sum 43.5% per item 2 above plus the 29.0% for renovations).
5. The parties agree that the amount of interest expense capitalized on renovations that should have been expensed was \$1,266,485 (29.0% x \$4,367,191 total interest cost).

None of the interest related to the renovations addressed in Stipulation #5 above was included in the Provider's fiscal year ended August 31, 1986 (FY 86) cost report as part of allowable interest expense. Since the \$4.7 million of renovations were completed in FY 86, the Provider is requesting that 29% of the total 1986 interest (\$1,266,485) be allowed as part of the current year's interest expense.

The Intermediary argues that since all interest expense for FY 86 has been accounted for and either capitalized or expensed, any capitalized interest in future years (FY 87-FY 89) could not be reduced in those years because the Intermediary was barred from reopening the Provider's cost report due to regulatory limitations. Further, the Intermediary believes that all capitalized interest has been recouped through the Provider's depreciation allowances after the Provider's facilities were put into service.

#### Issue No. 2 – Hillcrest Medical Tower (HMT) Interest Offset Calculation

The Parties agree that audit adjustment number 3 properly disallowed \$175,470 in interest expense claimed for Hillcrest Medical Tower (HMT), a non-allowable medical office building. They also agree that audit adjustment number 52 properly offsets additional non-allowable interest expense of \$3,074. Prior to the hearing, however, the Provider challenged the methodology employed by the Intermediary to compute allowable current year and capitalized interest. The Intermediary's computation deducted the audit adjustments (3 and 52) from allowable current year interest expense. The Provider argues that the adjustments should have been deducted from total interest expense first, with the balance of allowable interest expense being allocated between current year interest expense and capitalized interest. The reimbursement impact using the Provider's computation methodology is an increase of approximately \$17,381.

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<sup>1</sup> FASB 34 is at Exhibit P-20 to the Provider's final position paper.

With regard to Issues No. 3 through 9, the parties have stipulated to the treatment and disposition of these items as follows:

Issue No. 3 – Accrued FICA Expense

1. The parties acknowledge as correct, the reconciliation of FICA expense between IRS Form 941 as supported by the IRS Form 941s, and the General Ledger account for FICA Expense as set forth in Provider Exhibit P-2.
2. The Parties agree that the “reasonableness test” performed by the Intermediary auditor on workpaper B-4 (P-9) was not an appropriate finding based on audit evidence to support the adjustment disallowing accrued FICA expense.
3. The parties agree that regulation 413.24(b)(2) allows reimbursement of costs in accordance with the accrual basis of accounting.
4. The parties agree that the employer’s portion of the accrued FICA expense in the amount of \$124,326 (disallowed by adjustment number 5) had been properly accrued by the Provider and should be an allowable cost in the fiscal 1986 cost report.

Issue No. 4 – Cafeteria Meals Revenue Offset

1. The parties agree that the Intermediary’s calculation of the average meal price of \$4.79 on workpaper F-4 (see P-11) was in error since it failed to recognize the 15 percent employee discount on cafeteria meals.
2. The parties agree the cafeteria revenue offset in adjustment number 31 should be modified based on the following calculation:

	<u>Adjustment 31</u>	<u>As Revised</u>
Employee Meal Count	128,802	128,802
Average Price Per Meal	<u>x \$4.79</u>	<u>x \$3.40</u>
Cafeteria Revenue Offset	\$616,962	\$437,927

3. The parties agree that the revised cafeteria revenue offset complies with PRM 15-1 §§2304 and 2328.
4. The parties acknowledge that the cafeteria revenue offset issue for fiscal 1990 was administratively resolved pursuant to the same methodology.

Issue No. 5 – Bond Cost Amortization (1984 and 1985 Bonds)

1. The parties acknowledge that the 1984 bonds were refunded prior to maturity and redeemed immediately from a portion of the proceeds of the 1985 bonds as

- reflected in P-4, P-14, and P-15 and footnote 6 of the audited financial statements (P-23).
2. The parties acknowledge that \$86,470 of 1985 bond issue cost amortization (P-23) was related to expenditures for construction and renovation. Those costs were allowed in accordance with the interest expense/capitalization ratio (33.6% expense and 66.4% capitalization).
  3. The parties agree that the unamortized issuance cost of the 1984 bonds was \$495,701 as set forth on Intermediary workpaper E-1/5 (P-16) and the current period expense was limited to \$166,665 ( $\$495,701 \times 33.6\%$ ) based on application of the interest expense/capitalization ratio (33.6% expense and 66.4% capitalization).
  4. The parties agree that pursuant to PRM 15-1, Section 233 that the unamortized costs of bonds refunded before maturity are recognized as allowable in the period in which the refunded debt is repaid. The parties further acknowledge that the 1984 bonds were immediately refunded by the proceeds of the 1985 bonds in fiscal 1986.
  5. The parties agree that the proceeds of the 1984 bonds were unrelated to the 1985 construction and renovation project (P-4, P-14, and P-15), and accordingly, the interest expense/capitalization ratio should not have been applied and the full costs were allowable in fiscal 1986.
  6. The parties agree that adjustment number 2 should be modified to allow the full \$495,701 of unamortized 1984 bond issuance costs and accordingly an additional \$329,046 ( $\$495,701 - \$166,665$ ) should be added as allowable capital cost.

#### Issue No. 6 – Debt Cancellation Costs – 1984 Bonds

1. The parties acknowledge that the Provider originally claimed in the as filed cost report \$5,561,721 loss on advance refunding as a period cost in 1986, and such costs were disallowed by adjustment number 2. It is agreed by the parties that the loss on advance refunding claimed by the Provider included 1984 bond “Cancellation Costs” in the amount of \$78,568.
2. The parties acknowledges as complete and accurate the detail documentation (P-3) in support of the debt cancellation costs which include copies of original invoices and an allocation of certain costs between the 1984 bonds and 1985 bonds.
3. The parties agree that pursuant to PRM 15-1, Section 233 that debt cancellation costs of bonds refunded before maturity are recognized as allowable in the period in which the debt is refunded and such costs are paid. The parties further agree

that the 1984 bonds were fully repaid in 1986, and the debt cancellation costs were paid from the proceeds of the 1985 bonds in fiscal 1986.

4. The parties agree that adjustment number 2 should be modified to add \$78,568 as allowable capital cost for the debt cancellation cost incurred.

#### Issue No. 7 – Depreciation Expense on Assets Placed In Service

1. The parties acknowledge that the Provider's financial auditing firm adjusted depreciation expense to recognize those assets recorded in Construction in Progress (CIP) which had been placed in service during 1986, but the assets had not been transferred to the depreciation register (P-40) as of year end.
2. The parties acknowledge that the Provider recorded the depreciation expense as Journal Entry number 209 (audit firm adjustment number 47) in the amount of \$162,657 (P-78) and acknowledge receipt of this exhibit on June 2, 2003 during the administrative resolution negotiations.
3. The parties agree that depreciation expense for assets described in Journal Entry number 209 must be computed consistently with the treatment of the Construction in Progress, e.g., if CIP is transferred into service and the assets are used in the activities of the business, then under the "matching principle" the depreciation cost must be calculated.
4. The parties agree that the assets placed in service per the financial auditor's workpapers (P-40) are the same amounts claimed by the Provider as those renovations which were placed in service and therefore should be recognized as a modification of the interest expense/capitalization ratio (P-60).
5. The parties agree that the depreciation expense claimed by the Provider, and adjusted by the Intermediary number 9 in the amount of \$160,325 represents an accurate calculation (including allowable depreciation methods and useful lives) of the depreciation on the CIP which was placed in service during fiscal 1986, and audit adjustment number 9 was in error and should be reversed.
6. The parties acknowledge the Provider has submitted supporting documentation set forth in Provider exhibits P-25, P-26, P-27, P-40, P-45, P-47, P-48, P-55 and P-60 which evidences the Provider's position that a portion of the CIP had been placed into service during 1986 and was used to generate routine and ancillary revenues during 1986.
7. The parties acknowledge there are three dates involved in this dispute: (1) the date an asset is substantially complete and placed in service; (2) the date when the accounting department summarizes the construction/renovation costs as final; and (3) the date when the assets are transferred from CIP to the depreciation register. Depreciation on assets requires adequate auditable documentation. The parties

agree that the first date, when an asset is placed in service, is the most relevant for determining when interest capitalization should cease and depreciation should begin (P-67).

#### Issue No. 8 – Unnecessary Borrowing

1. The parties agree that the 1984 bond proceeds funded the construction project in the amount of \$22,105,000 (P-14).
2. The parties agree that the total cost of the project was in excess of \$34 million (P-13, P-31, and P-79).
3. The parties acknowledge that the Provider did not have excess working capital or available funded depreciation (beyond \$2.88 million which was used to fund a portion of the project cost overruns) at the time of the financing, as documented in the audited balance sheet as of 8-31-86 (P-46). Accordingly, the borrowing was necessary in light of the total project cost compared to the amount of available funds and debt issued.
4. The parties agree that the borrowing was necessary for an allowable patient care services project, and the interest rate was “proper” as defined by Medicare, determined in the open market between unrelated parties in accordance with PRM Section 202.
5. The parties agree that the interest on the 1985 bond was comprised of interest on the “term bonds” plus interest on the “zero coupon bonds” and in accordance with PRM Section 213 interest on zero coupon bonds is an allowable cost (P-6).
6. The parties agree that the unnecessary borrowing determination reflected on Intermediary workpaper E-1/8 (P-16) has been reviewed, and the 1985 Bonds have been determined to be necessary.
7. The audit adjustment number 4 which disallowed \$92,188 of interest expense is in error and should be reversed.

#### Issue No. 9 – Zero Coupon Bond Interest

1. The parties agree that the interest expense on the 1985 bonds was comprised of interest on the “term bonds” plus interest on the “zero coupon bonds,” and in accordance with PRM Section 213 (P-6) interest on zero coupon bonds is an allowable cost.

#### FINDINGS OF FACT, CONCLUSION OF LAW AND DISCUSSION:

The Board, after considering the Medicare law, program instructions, the evidence and the parties’ contentions finds and concludes as follows:

### Issue No. 1 – Current Expense v. Capitalized

Interest expense incurred in 1986 relating to renovation expense incurred that year is not allowable as a current operating expense.

The Board's decision on the treatment of the \$1.2 million of interest related to the \$4.6 million of renovations completed in FY 86 is based on what the Provider actually did in recording interest expense on its books and the Medicare cost report as opposed to what the Provider now wishes to do based on its re-examination of the facts relating to its renovations. The Board observes that the Provider chose to capitalize all of the interest expense relating to the new construction and renovations of its campus. The Intermediary accepted the Provider's treatment of this expense and did not challenge the Provider's original approach of calculating interest related to the renovations. The Board finds that the Provider, therefore, elected an accounting treatment that did not take advantage of Medicare's more favorable reimbursement policy of allowing interest expense for renovations in the year in which the cost is incurred. Instead, the Provider chose to capitalize the interest expense as part of the cost of renovations, thereby deferring the related reimbursement to future years when depreciation would be allowed over the useful life of the renovations. The Intermediary contends that the Provider is bound to continue using the same methodology and the Board concurs. The Provider is made whole and reimbursed over the life of the facility. The Intermediary has clearly shown that all interest expense incurred was accounted for from 1986 – 1988. That interest was allocated between current and capitalized interest based on undisputed percentages. Further, when the facilities were put into use, the Provider was reimbursed capitalized interest through its depreciation allowance. Therefore, the Provider's concerns over whether capitalized interest was included in the 1987-1990 cost reports and the Intermediary's concern that, if the disputed interest on renovations were allowed, the 1987-1990 cost reports could not be reopened to remove the same interest claimed in later years under 42 C.F.R. §405.1855, are now moot. Finally, the Board concludes that the Provider's original decision to capitalize all renovation interest resulted in the appropriate payment of interest made over the long-term via the Provider's depreciation allowance.

### Issue No. 2 – HMT Offset Calculation

The Intermediary concurs with the Provider's proposed offset methodology and the mechanics of the calculation as proposed by the Provider in exhibit P-81. However, the Intermediary does not agree that a 72.5% completion percentage should be applied to determine allowable interest expense. The Intermediary has only agreed to use a 43.5% completion ratio (page 5 of the Intermediary's post-hearing brief). Since the Provider offered no argument as to why the revised ratio was more appropriate, and the burden of proof to support the allowability of costs and related allocations is on the Provider, the Board concludes that the Intermediary's percentage used to calculate current interest to expense is reasonable and acceptable.

Issue No. 3 – Accrued FICA Expense

Based on the evidence established in the above stipulation for issue number 3, the Board finds that the employer's portion of accrued FICA expense has been properly accrued and is allowable.

Issue No. 4 – Cafeteria Meals Revenue Offset

Based on the evidence established in the above stipulation for issue number 4, the Board finds that the cafeteria revenues have been properly offset based on the revised calculation agreed upon by the parties.

Issue No. 5 – Bond Cost Amortization (1984 and 1985 Bonds)

Based on the evidence established in the above stipulation for issue number 5, the Board finds that the parties' agreed that the amount of the unamortized bond issuance costs have been properly determined, and that those costs are allowable as an additional capital cost.

Issue No. 6 – Debt Cancellation Costs – 1984 Bonds

Based on the evidence established in the above stipulation for issue number 6, the Board finds that the parties' agreed upon debt cancellation costs are allowable capital costs.

Issue No. 7 – Depreciation Expense On Assets Placed In Service

Based on the evidence established in the above stipulation for issue number 7, the Board finds that all of the depreciation adjustments agreed upon by the parties are appropriate.

Issue No. 8 – Unnecessary Borrowing

Based on the evidence established in the above stipulation for issue number 8, the Board finds that the necessary borrowing determinations made by the parties were proper, and that the Intermediary's disallowance of interest expenses should be reversed.

Issue No. 9 – Zero Coupon Bond Interest

Based upon the evidence established in the above stipulation for issue number 9, the Board finds that the interest expense on zero coupon bonds is allowable.

DECISION AND ORDER:Issue 1 – Current Expense v. Capitalization

The interest expense related to the 1986 renovations remains part of capitalized interest and cannot be considered a current expense in 1986. The Intermediary's acceptance of the Provider's original treatment of this cost is affirmed.

Issue 2 – HMT Offset Calculation

The 43.5% used by the Intermediary to allocate the current period portion of interest expense is reasonable and allowable. The Intermediary's adjustment is modified to be consistent with the methodology in Provider Exhibit P-81.

Issues 3-9 - Various Issues Subject to Administrative Resolution

The determination of payment as reflected in the Parties' Administrative Resolution are affirmed.

BOARD MEMBERS PARTICIPATING:

Suzanne Cochran, Esquire  
Elaine Crews Powell, C.P.A.  
Anjali Mulchandani-West, C.P.A.  
Yvette C. Hayes  
Michael D. Richards, C.P.A.

FOR THE BOARD:

Suzanne Cochran, Esquire  
Chairperson

DATE: February 4, 2008