PROVIDER REIMBURSEMENT REVIEW BOARD
HEARING DECISION

ON THE RECORD
2002-D2

PROVIDER -
Summit Care Corporation 95 Pharmacy Costs Group

Provider No. Various

vs.

INTERMEDIARY -
Blue Cross and Blue Shield Association/ United Government Services, LLC-CA (formerly Blue Cross of California)

DATE OF HEARING-
September 19, 2001

Cost Reporting Period Ended -
June 30, 1995

CASE NO. 97-1280G

INDEX

ISSUE:

Did the Intermediary properly reimburse the Provider for drugs and medical supplies purchased from a related party?

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

Summit Care Corporation ("Provider") is a chain organization headquartered in Burbank, California.[1] During the fiscal year ended June 30, 1995, it owned various skilled nursing facilities ("SNFs") also located in California. Eight of the Provider's SNFs, which are part of this appeal, purchased drugs and medical supplies from two pharmacies--one located in Pasadena, California, and the other located in Yorba Linda, California. These two pharmacies were owned by Skilled Care Pharmacy, Inc., which was a wholly owned subsidiary of the Provider.[2]

In preparing the subject SNFs' cost reports for 1995, the Provider applied Medicare's related organization rule found at 42 C.F.R. § 413.17. That is, the Provider claimed only the costs incurred by the related party pharmacies for the drugs and medical supplies its SNFs purchased from them. At issue in this appeal is the methodology used to determine the amount of those costs.

The methodology used by the Provider in its as-filed cost reports was based upon the costs incurred by the pharmacies, separately calculated for two different product lines, i.e., drugs and medical supplies, and the individual SNFs' charges.[3] In general, the Provider calculated a "profit percentage" for each product line, and reduced the pharmacies' charges to each SNF by that percentage to determine their cost.

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[1] Through a merger that occurred in March 1998, Summit Care Corporation became Fountain View, Inc.

[2] Provider Position Paper at 1.

[3] The Provider explains that the pharmacy located in Pasadena sold only drugs, while the pharmacy located in Yorba Linda sold both drugs and medical supplies.

In particular, the Provider calculated the profit percentages by reducing the pharmacies' gross charges for bad debts and for Medicare and Medi-Cal contractual allowances to determine net revenue. Next, the Provider subtracted the pharmacies' total costs from the net revenue amount to determine a net profit amount. The profit percentage was then determined by dividing net profit by net revenue.[4]

Blue Cross of California ("Intermediary") reviewed the Provider's cost reports and perfected adjustments modifying the methodology used by the Provider to determine its related party costs. First the Intermediary added back the Medicare and Medi-Cal contractual allowances and bad debts offset by the Provider in its profit percentage calculations. Then the Intermediary calculated a profit percentage for each of the two pharmacy locations and applied them to the individual SNFs' charges as opposed to using separate profit percentages for each of the two product lines as proffered by the Provider.

[4] See Exhibit P-4.

Between September 20, 1996 and September 27, 1996, the Intermediary issued a Notice of Program Reimbursement reflecting its adjustments in each of the subject provider cost reports. On March 18, 1997, the Provider appealed the adjustments to the Provider Reimbursement Review Board ("Board") pursuant to 42 C.F.R §§ 405.1835-.1841 and met the jurisdictional requirements of those regulations. The amount of program funds in controversy is approximately $60,000.[5]

The Provider was represented by Jeffrey R. Bates, Esq., of Foley & Lardner. The Intermediary was represented by Bernard M. Talbert, Esq., Associate Counsel, Blue Cross and Blue Shield Association.

PROVIDER'S CONTENTIONS:

The Provider contends that the issue in this case is the correct application of Medicare's related party rule.[6] The pertinent regulations provide that in determining the amount of a provider's allowable costs, any profit generated as a result of transactions between related parties must be removed and the provider's costs limited to the costs of the related party. In part, 42 C.F.R. § 413.17 states:

> 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 services, facilities, or supplies that could be purchased elsewhere.

42 C.F.R. § 413.17.[7]

The Provider contends that the Intermediary's adjustments pertaining to bad debts and Medicare

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[5] See Appendix

[6] Provider Position Paper at 7.

[7] See also Provider Reimbursement Manual, Part I ("HCFA Pub. 15-1") § 1000 et seq.

and Medi-Cal contractual allowances are improper. The Provider asserts that in determining the pharmacies' profit percentages, charges must be reduced by the Medicare and Medi-Cal contractual allowances and bad debts to avoid an incorrect overstatement of pharmacy revenue.

The Provider explains that the pharmacies directly billed the Medicare and Medi-Cal programs for certain drugs and medical supplies provided to program beneficiaries. In their accounting records the pharmacies recorded their charges to these programs for the products in question. However, the Medicare and Medi-Cal programs do not reimburse providers for drugs and medical supplies based upon charges. The Medicare and Medi-Cal contractual allowances were included in the pharmacies' accounting records to reflect the fact that the actual revenue to the pharmacies from these programs would be less than the amounts charged.

Similarly, the Provider maintains that the pharmacies' charges should be reduced by the amount of bad debts attributable to their sales. This adjustment, also included in the pharmacies' accounting records, reflects the fact that the pharmacies' revenue was, in fact, less than their charges.

The Provider asserts that it is more accurate to allocate the pharmacies' costs to the subject SNFs on the basis of revenue rather than on the basis of charges. Therefore, it reduced the pharmacies' charges by the contractual allowances and bad debts to reflect that these amounts would never become actual revenue of the pharmacies. The contractual allowances and bad debts are similar to the adjustments made by the Provider for "discounts," which the Intermediary approved.[8]

The Provider also contends that the methodology used by the Intermediary is arbitrary and illogical.[9] The Provider explains that the Intermediary calculated a profit percentage for the drugs sold by the Pasadena pharmacy and applied that percentage to the sales of drugs by both pharmacies. Similarly, the Intermediary calculated a profit percentage for the Yorba Linda pharmacy, which sold both drugs and medical supplies, and applied it only to the sales of that pharmacy's medical supplies.[10] The Provider asserts that there is no rational basis for this application. The profit percentage calculated for the drugs sold by the Pasadena pharmacy has no relevance to the profit earned by the Yorba Linda pharmacy. Moreover, the profit percentage

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[8] See e.g., Exhibit P-4.

[9] Provider Position Paper at 9.

[10] Exhibit P-2.

calculated for the Yorba Linda pharmacy includes the cost of drugs but was applied only to the cost of medical supplies.

The Provider submits that the profit percentages, correctly calculated by product, should be applied to the same sales upon which the percentages were based. In the instant case there are two different pharmacy lines of business with substantially different profit percentages and Medicare utilization. Accordingly, recognizing the two different product lines in the cost apportionment process results in a far more accurate determination of the costs related to the care of Medicare beneficiaries than the Intermediary's calculations.

The Provider notes that the Medicare cost report has separate lines for reporting the costs of drugs and the costs of medical supplies. The cost apportionment methodology it used allows for the most accurate reporting of costs for each of these cost center lines by separately determining the cost of drugs and the cost of medical supplies, including the cost of drugs and medical supplies purchased from related party pharmacies. In contrast, the Intermediary's methodology aggregates certain drug and medical supply costs together and results in a less accurate cost finding.

The Provider explains that the two different pharmacy product lines, drugs and medical supplies, have significantly different direct and indirect costs. The medical supplies product line is considerably more profitable than the drugs product line and has a substantially higher profit percentage. The most appropriate method of calculating the profit percentage is to calculate the percentage for each product line and apply that percentage separately to their respective sales.

Finally, the Provider contends that the Intermediary's calculations fail to reflect the allowable costs of its home office. The Provider notes, however, that the Intermediary indicates in its position paper that it will revise its calculations for these additional expenses.

INTERMEDIARY'S CONTENTIONS:

The Intermediary contends that its calculations, which include bad debts and contractual allowances in the Provider's profit percentage determinations, are proper.[11] The methodology used by the Provider produces an increase in program costs stemming from bad debts and contractual allowances that are contrary to Medicare rules at 42 C.F.R. § 413.80 et seq.

The Intermediary explains that Medicare specifically limits the reimbursement of bad debts to Medicare deductibles and coinsurance. However, the Provider attempts to include in reasonable costs a factor for bad debts not applicable to Medicare beneficiaries. The Intermediary cites 42 C.F.R. §§ 413.80(d) and (e), which state:

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[11] Intermediary Position Paper 3.

> *[r]equirements for Medicare*. Under Medicare, costs of covered services furnished beneficiaries are not to be borne by individuals not covered by the Medicare program, and conversely, costs of services provided for other than beneficiaries are not to be borne by the Medicare program. Uncollected revenue related to services furnished to beneficiaries of the program generally means the provider has not recovered the cost of services covered by that revenue. The failure of beneficiaries to pay the deductible and coinsurance amounts could result in the related costs of covered services being borne by other than Medicare beneficiaries. To assure that such covered service costs are not borne by others, the costs attributable to the deductible and coinsurance amounts that remain unpaid are added to the Medicare share of allowable costs. Bad debts arising from other sources are not allowable costs.
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> (e) *Criteria for allowable bad debt.* A bad debt must meet the following criteria to be allowable:
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> (1)The debt must be related to covered services and derived from deductible and coinsurance amounts.
>
> (2)The provider must be able to establish that reasonable collection efforts were made.
>
> (3)The debt was actually uncollectible when claimed as worthless.
>
> (4)Sound business judgment established that there was no likelihood of recovery at any time in the future.

42 C.F.R. §§ 413.80(d) and (e).

With respect to the Provider's attempt to exclude contractual allowances from the profit percentage calculation, the Intermediary also cites HCFA Pub. 15-1 § 328, which states:

> [c]harity, courtesy, and third-party payer allowances are not reimbursable Medicare costs. Charges related to services subject to these allowances should be recorded at the full amount charged to all patients, and the allowances should be appropriately shown in a revenue reduction account. <u>The amount reflecting full charges must then be used as applicable to apportion costs</u> and in determining customary charges for application of the lower of costs or charges provision.

HCFA Pub. 15-1 § 328 (emphasis added).

The Intermediary contends that the Provider, in its as-filed cost reports, calculated an 8.25 profit

percentage for drugs and a 22.61 percentage for medical supplies. Exhibit I-4. The Provider now believes that these percentages should be 4.34 percent and 26.41 percent, respectively, based upon the inclusion of home office costs. The Intermediary asserts that its omission of home office adjustments from the Provider's settlements will be administratively resolved.

Finally, the Intermediary notes the Provider's position that the profit calculations should be based upon the two individual product lines rather than pharmacy location. Regarding this matter, the Intermediary asserts that if the Board determines that the related party profit percentages should be applied based upon pharmacy location, the Provider believes the profit percentage for the Pasadena pharmacy is .65 percent and the profit percentage for the Yorba Linda pharmacy is 17.61 percent.[12]

CITATION OF LAW, REGULATIONS AND PROGRAM INSTRUCTIONS:

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

§ 405.1835-.1841	-	Board Jurisdiction
§ 413.17	-	Cost to Related Organization
§ 413.80 et seq.	-	Bad Debts, Charity, and Courtesy Allowances

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

§ 328	-	Charity, Courtesy, and Third Party Payer Allowances-Cost Treatment
§ 1000 et seq.	-	Cost to Related Organization

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DISCUSSION:

The Board, after consideration of the facts, parties' contentions, and evidence presented, finds and concludes as follows:

The issue in this case is a matter of determining the cost of services provided by related organizations. Eight commonly owned SNFs purchased drugs and medical supplies from two pharmacies--one located in Pasadena, California, and the other located in Yorba Linda, California. These two pharmacies were owned by the SNFs' parent corporation.

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[12] Exhibit I-5.

With respect to the cost of services provided by related organizations, regulations at 42 C.F.R. § 413.17 state in part:

> 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.

42 C.F.R. § 413.17.

Moreover, program instructions at HCFA Pub. 15-1 § 1005 state:

> [t]he 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.

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

The Provider and Intermediary agree, in principle, on the methodology for adjusting the individual SNF's costs to reflect the costs of the related pharmacies. In general, this methodology calculates the amount of profit, expressed as a percentage, within the pharmacies' sales, and then reduces the SNFs' purchases by those percentages. The disagreement between the parties pertains to the basis and approach for determining and applying the profit percentages.
In particular, the Provider contends that the calculations should be based upon a comparison of the pharmacies' costs to their net revenue, while the Intermediary contends that the pharmacies' costs should be compared to their gross charges. The Provider, in order to determine the pharmacies' net revenue, reduced their charges for bad debts and for Medicare and Medi-Cal contractual allowances. The Intermediary reversed or disallowed these reductions.[13]

In addition, the Provider explains that the pharmacy located in Pasadena sold only drugs, while the pharmacy located in Yorba Linda sold both drugs and medical supplies. Respectively, the Provider argues that a separate profit percentage should be calculated for each of these two product lines, i.e., one profit percentage should be determined for drugs and a separate profit percentage should be determined for supplies. Notably, the approach used by the Intermediary is quite different. The Intermediary calculated a profit percentage for drugs using the Pasadena pharmacy's cost and charge data and applied that percentage to the sale of drugs at both pharmacies. Also, the Intermediary calculated a profit percentage for the Yorba Linda

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[13] See e.g., Exhibit I-4.

pharmacy, which included drug costs, and applied it only to the sale of that pharmacy's medical supplies.[14]

In all, the Board finds that there are three facets to the issue in this case which need to be addressed. That is, whether or not the pharmacies' charges should be reduced by bad debts to determine a profit percentage, whether or not the pharmacies' charges should be reduced by Medicare and Medi-Cal allowances to determine a profit percentage, and whether or not profit percentages should be determined and applied by pharmacy location or by product line.

Respectively, the Board finds that the Intermediary properly included bad debts and Medicare and Medi-Cal contractual allowances in the profit percentage calculations. The Board agrees with the Intermediary that excluding these items from the profit percentage calculations results in program payments being improperly generated from "reductions in revenue" as opposed to allowable costs. Regulations at 42 C.F.R. § 413.80(a) and (c) state in part:

> (a) *Principle.* Bad debts, charity, and courtesy allowances are deductions from revenue and are not to be included in allowable cost. . . .
>
> (c) *Normal accounting treatment: Reductions in revenue.* Bad debts, charity, and courtesy allowances represent reductions in revenue. The failure to collect charges for services furnished does not add to the cost of providing the services. Such costs have already been incurred in the production of the services.

42 C.F.R. § 413.80(a) and (c).

As noted above: "[t]he intent [of Medicare's related party rule] is to treat the costs incurred by the supplier as if they were incurred by the provider itself." HCFA Pub. 15-1 § 1005.

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[14] Id.

The Board also finds, however, no rational support for the approach used by the Intermediary whereby a profit percentage calculated from one pharmacy's operations is applied to the sales of a second freestanding pharmacy, which has its own profit percentage data. Similarly, the Board finds that the approach presented by the Provider where costs and charges of the two pharmacies are combined to yield a profit percentage is not the best approach to be used in the instant case. Rather, the Board finds that the most accurate way to determine and apply profit percentages is to match costs directly with their associated charges. The Board concludes, therefore, that profit percentages should be determined and applied by pharmacy by product line. This means that a profit percentage should be calculated from the Pasadena pharmacy's drug cost and charge data, and that percentage should be applied only to the drugs sold by that pharmacy. Coinciding, a profit percentage should be calculated from the Yorba Linda pharmacy's drug cost and charge data and applied only to the drugs sold by that pharmacy. And, a separate profit percentage should be calculated from the Yorba Linda pharmacy's supplies cost and charge data and applied to the supplies sold by that pharmacy. With respect to this matter, the Board notes that the Provider maintains the data necessary to determine and apply profit percentages by pharmacy by product line.[15]

The Board also notes that while the Intermediary included bad debts and Medicare and Medi-Cal allowances in the determination of the pharmacies' profit percentages pursuant to 42 C.F.R. § 413.80, it did not require "discounts" to also be included.

And finally, the Board notes that the Intermediary had not included the Provider's home office costs in its profit percentage calculations. The Intermediary explains in its position paper, however, that any such omissions will be administratively resolved.

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[15] See e.g., Exhibits P-4 and P-5.

DECISION AND ORDER:

The Intermediary did not properly reimburse the Provider for drugs and medical supplies purchased from a related party. The Intermediary properly included bad debts and Medicare and Medi-Cal allowances in its profit percentage calculations. However, the Intermediary did not use the most accurate approach for its calculations. The Intermediary is to determine and apply a profit percentage by pharmacy by product line, as described herein, to determine the Provider's costs. The Intermediary's adjustments are modified.

Board Members Participating:

Irvin W. Kues
Henry C. Wessman, Esq.
Stanley J. Sokolove
Dr. Gary Blodgett

Date of Decision: December 12, 2001

FOR THE BOARD:

Irvin W. Kues
Chairman