CAPITAL-RELATED COSTS (EXCEPT INTEREST)

This exhibit applies to all providers. In addition, for PPS hospitals, see Exhibit 6A, PPS Capital Audit Guidelines.

Regulation Reference: 42 CFR 413.134 through 413.149

OBJECTIVES: 1. To determine that depreciation is stated in accordance with current Medicare principles of reimbursement.

a. Based on the historical cost in the case of a purchased asset or fair market value in the case of a donated or inherited asset. See DEFRA, §2314.

b. Prorated over the estimated useful life of the assets.

2. To determine that current summary schedules that reflect the costs of fixed assets and the related depreciation claimed under the program are maintained.

3. To ascertain that additions and/or acquisitions are properly capitalized in accordance with the provider's capitalization policy and recorded at cost.

4. To determine that gains or losses on disposal of assets are accounted for in accordance with PRM-I, §132.

5. To determine that accelerated depreciation, if taken under the program, was properly claimed or recaptured where applicable (see PRM-I, §§116 and 136).

6. To determine that the methods adopted for computing depreciation expense are adhered to.

7. To determine that service contract costs are correctly identified as operating costs or capital-related costs, as appropriate, in accordance with PRM-I, §§108.2 and 2806.3.

8. To determine that lease/rental costs are reported in accordance with PRM-I, §§110 and 2136.1.B.

9. To ensure that where an appraisal has been made, the basis, all applicable assets and related depreciation are in compliance with HCFA-Pub. 15-1, §134.

OTHER REFERENCES:

PRM-I, Chapter 1

Cost Report Forms: Hospital:

HCFA-2552, Worksheet A

HCFA-2552, Worksheet A-7
HCFA-2552, Worksheet A-8

HCFA-2552, Worksheet B-1

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HOSPITAL AND SKILLED NURSING FACILITY AUDIT PROGRAM (1999)

STEP	PROCEDURE DESCRIPTION	AUDITOR'S INITIALS AND DATE	WP REF

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DEPRECIATION RECONCILIATION

1. Reconcile the provider's detailed records of depreciation expense to the working trial balance, fixed asset records, financial statements and Worksheet A-7. Where the data does not reconcile, request the provider to explain the variance. Propose audit adjustments, where necessary.

REVIEW CAPITALIZATION/DEPRECIATION POLICY

2. Obtain and review the provider's capitalization policy, keeping a copy in the permanent file for reference. Ascertain that the policy is in conformity with Medicare principles of reimbursement and obtain an understanding of the policies and procedures used for:

   A. Determining the basis for depreciation.

   B. Determining the method of computing depreciation expense for financial statement purposes.

   C. Determining the method used to compute depreciation expense for Medicare purposes.

   D. Capitalizing minor equipment acquisitions, betterments and improvements, and additions. If the provider's capitalization policy does not meet Medicare regulations as specified in PRM-I, §106, make an observation and recommendation to the provider or adjustments as appropriate.

   E. Determining the effective date to begin depreciation of an asset, such as half-year depreciation in the year of acquisition, actual time depreciation, and time lag alternatives and whether the policy is different for different classes of assets. Document when the asset was placed in service for patient care.

   F. Assigning estimated life to depreciable assets. If the provider's capitalization policy does not meet Medicare regulations as specified in PRM-I, §108, make an observation and recommendation to the provider or adjustments as appropriate.

CURRENT YEAR ACQUISITIONS

3. Obtain the provider's listing of asset acquisitions and select a sample of items for review. If significant problems are noted, consider reviewing prior year acquisitions.

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A. Determine that the assets were classified properly as building, furniture and fixtures, equipment, etc. To the extent possible, determine that the assets are related to patient care and include no inventory items.

B. Determine if new acquisitions meet the capitalization threshold. Consult the provider's capitalization policy in the permanent file for consistency.

C. Verify the historical cost of the asset by vouching to invoices, or by other means, as appropriate. While checking the invoices, ensure that the provider has not capitalized what is normally considered maintenance and repair expenses. Determine whether the provider has capitalized supply items that should have been expensed or inventoried.

D. Determine that the life or rate of depreciation is in accordance with the American Hospital Association (AHA) useful life of assets guidelines currently recognized by HCFA. However, FIs have the authority to approve a different useful life if a provider makes such a request prospectively and provides adequate documentation (refer to 42 CFR 413.134(b)(7)(i); see also PRM-I, §104.17.

E. Recompute the depreciation in accordance with Medicare principles of reimbursement and the provider's depreciation policy.

F. Ensure that the depreciation reported in the year of acquisition is in accordance with PRM-I, §118, and the provider's capitalization policy. However, buildings, both old and new, acquired and put into use for patient care in cost reporting periods beginning on or after April 1, 1983, must be depreciated on the actual time basis.

Note: For assets acquired after July 1970, the straight-line method of depreciation must be used unless it results in insufficient cash flow, as defined in PRM-I, §116C. If cash flow is insufficient, the provider may use (only with specific permission of the intermediary for each asset involved) a declining balance method not to exceed 150 percent of the straight-line rate. If other than the straight line method was used, perform step 4.

G. Ensure that capitalization of minor equipment conforms

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to the established capitalization policy (see Exhibit 6, step 2). If capitalization of group purchases occurs, make sure items in the group are homogeneous.

H. Make a physical inspection on a limited basis of new equipment on which depreciation was claimed, and note any old equipment which is no longer in use by performing the following audit steps:

1. Obtain an asset listing by department of equipment charged to the department, description of equipment and identification number.

2. From the asset listing, select a sample of equipment items to be inspected and perform the physical inspection.

3. Determine if the assets are still in use for patient care and if they are located in the respective departments for which depreciation was claimed. Discuss any apparent errors with provider personnel. Consider expanding the test to determine whether the misclassification is more pervasive. Propose an audit adjustment where assets are misclassified.

4. For any item of major equipment that is no longer in use, determine through discussion with provider personnel the status (obsolete, standby, etc.) of such equipment and whether it is properly reflected in the asset account. Refer to the sections on gain or loss, retirements, involuntary conversion and partial casualty losses for additional work that may be needed.

ACCELERATED DEPRECIATION

4. A provider may request to use accelerated depreciation if it can demonstrate that a cash flow need exists (PRM-I, §116). If accelerated depreciation is being used, perform the following steps:

A. Where accelerated depreciation is used for assets acquired on or after August 1, 1970, determine that intermediary approval has been obtained.

B. Obtain documentation to support the claim that cash flow is insufficient to provide funds required to meet

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the principal amortization schedules on the capital debts related to the provider's total depreciable assets used to provide patient care.

C. From documentation obtained in the previous audit step, determine the following:

1. That the proper basis for depreciation is used.

2. The mathematical accuracy of the supporting schedules so that a determination can be made as to whether a cash flow need exists.

CHANGE IN METHOD OF DEPRECIATION AND RELIFING OF ASSETS

5. A. Review the permanent file, financial statements, Form HCFA-339 and outside auditor's workpapers for any evidence of relifing.

B. On a sample basis for major existing assets, recompute depreciation expense, using a life the provider used in the prior period and straight-line method of depreciation. Verify the provider's use of straight-line depreciation and be aware of any occurrence of asset relifing.

Note: All assets must be considered by the provider for relifing, not just those assets that give positive reimbursement when relifed (see PRM-I, §122).

C. Where an asset has been relifed, ensure the provider has written intermediary approval prior to the beginning of the cost reporting period in which the relifing occurred. Where the provider failed to obtain prior intermediary approval, propose an audit adjustment to correct the depreciation claimed.

D. Review the relifing of assets acquired prior to the entrance into the Medicare program. Appraisal firms have developed an asset relifing program that may shift a disproportionate share of depreciation applicable to fully depreciated pre-Medicare assets to the years under Medicare. Assets that have been fully depreciated may not be relifed even though they are still in use.

Note: This is accomplished by extending the lives of pre-Medicare assets that are fully depreciated under the

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program, on a year-to-year basis, until the assets are actually retired. Since many of these assets were already relifed once after the provider's entrance into the program, ensure that further depreciation is not allowed, even though the asset may continue to be used (42 CFR 413.144(b) and PRM-I, §122).

DIRECTLY ASSIGNED CAPITAL-RELATED COST

6. Obtain a copy of and review the provider's procedure for directly assigning capital-related cost to individual cost centers. Review the propriety of direct assignment of capital-related cost and the classification as capital-related or operating cost. (See 42 CFR 413.130, PRM-I, §2307.) Examine documentation supporting the basis for the direct assignment. Do not duplicate work done in the General section of the audit program.

   A. Where cost is directly assigned to individual cost centers and identified as capital-related cost, ensure that the directly assigned cost is not an operating cost, for example, maintenance and repairs cost.

   B. Determine that the basis used for the direct assignment is correct.

   C. Explain material variances from the prior year by cost center.

   D. Select a sample of departments in which directly assigned capital-related costs are significant and verify the propriety of the cost claimed. Where your tests are based on a sample that is not statistically valid, you should expand the sample to verify that the expanded sample is representative of the population. However, if in your judgment the amount sampled is representative of the population, then you do not need to expand the sample The audit adjustments should reflect the population and not just the errors in the original sample.

RENT OR LEASE EXPENSE

7. A. Where rent expense is allowed as a capital cost, ensure that the permanent file contains a copy or extract of major leases, rental agreements or similar contracts. A schedule should be prepared showing the amount of lease expense and where it is reported. Document definition of materiality.

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B. If material and scoped for review, analyze rent and lease expense for the cost reporting period and determine the nature of the leases.

C. Reconcile a sample of the rent or lease expense to the general ledger. Where errors are noted, and your tests are based on a sample that is not statistically valid, you should consider expanding the sample to verify that the expanded sample is representative of the population. However, if in your judgment the amount sampled is representative of the population, then you do not need to expand the sample. The audit adjustments should reflect the population and not just the errors in the original or expanded sample.

D. Ascertain that rent expenses paid or incurred between related parties are in accordance with Medicare reimbursement principles. (See Exhibit 8 for related organizations.)

E. Sale and Leaseback Arrangements (see PRM-I, §110A) - If a determination is made that a sale or leaseback agreement for plant facilities or equipment is entered into with a related party, ensure that reimbursement treatment of the transaction is in accordance with PRM-I, §§1011.5, 110A and 110B.

Determine if any sale and leaseback agreements for plant facilities or equipment were entered into with a nonrelated party. If the rent specified in the agreement is included in allowable cost, determine:

1. That rent expense is reasonable, based on consideration of rental charges of comparable facilities.

2. Adequate alternate facilities or equipment were not available at lower cost.

3. Leasing was based on economic and technical considerations.

If all these conditions are not met, the rental charge cannot exceed the amount that the provider would have included in reimbursable costs had it retained legal title to the facilities or equipment, such as interest on mortgage, taxes, depreciation, insurance and

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maintenance costs.

F. Lease Purchase Agreements - Some lease agreements are essentially the same as installment purchases of facilities or equipment. (See PRM-I, §110B.)

1. For leases entered into on or after October 23, 1992, determine whether the lease meets any one of the conditions stated in 42 CFR 413.134(h)(6).

If you determine based on these tests that the lease is a virtual purchase, that is, the lease agreement is essentially the same as installment purchases of facilities or equipment, perform the following procedures:

2. Ensure that the amount claimed as rental expense for virtual purchase leases is limited to the amount that the provider could include in allowable cost if it had legal title to the assets (that is, depreciation on a straight-line basis, property taxes, insurance and interest).

3. Ensure that the difference between the amount of the rent paid and the amount allowed as rental expense is treated as a deferred expense. (This amount must be capitalized as part of the historical cost when the asset is purchased.)

4. If the asset is returned to the owner instead of being purchased, ascertain that the deferred expense was expensed in the year the asset was returned.

If you determine that the lease is not a virtual purchase, but is a normal lease, refer to Step A or B of this section.

Note: Medicare does not allow a capital lease (under GAAP) to be recorded as an asset. Providers must follow PRM-I, §110B.

G. Leases for nominal amounts - Determine if any facilities are leased for a nominal amount (see PRM-I, §112). This is done in some instances where a provider leases facilities from a municipality at $1.00 per year. If facilities are leased for a nominal amount, perform

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the following audit steps:

1. Determine that the cost of any improvements to the leased property is properly amortized.

2. PRM-I, §112.1, requires that each case be reviewed on its own merits to decide whether depreciation may be allowed. If the provider has included in its costs an amount to cover depreciation on the leased facilities, review the lease and determine that the following conditions are met:

   a. The lease must contemplate that the lessee will make necessary improvements to the leased facilities.

   b. The intent of lessor and lessee is to continue the lease arrangements for the useful life of the asset.

   c. The lease has no restrictions on the free use of the facility by the lessee.

   d. The lease does not provide any indirect benefits to the lessor.

   If these criteria are not met, then depreciation is not recognized.

3. Determine if the provider contributed any funds to retire the lessor's bonds or notes issued for the facility or made any other type of contribution to the lessor.

4. If it is determined in Step 3 that contributions were made and treated as rental expense, ensure that depreciation is not included in allowable costs.

5. Determine the basis and method used for depreciation and ensure that it complies with PRM-I, Chapter 1.

Any questions regarding the legal interpretation of the lease as it relates to these criteria should be submitted to the HCFA regional office for an opinion from the regional attorney.

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MAINTENANCE/PURCHASED SERVICE CONTRACTS

8. Review material maintenance/purchased service contracts to ensure appropriateness in treatment as capital-related or operating cost, in part or in total, as appropriate. Document definition of materiality.

   A. Identify maintenance/purchased service contracts which could have an effect on capital-related cost. Ensure that the provider has not attempted to treat what are normally maintenance and repair costs as capital-related costs.

   B. Ensure that capital-related cost in total excludes costs applicable to maintenance/purchased service contracts unless a portion of the contract amount meets the criteria of 42 CFR 413.130(h) and PRM-I, §108.2.

   C. If no amount is identified as maintenance on the lease agreement, the entire rental payment may be considered as capital related.

PROPERTY TAXES AND INSURANCE

9. A. Ensure that property taxes and insurance pertaining to nonreimbursable assets (those assets that are not related to patient care) are not included in provider pass-through costs. If necessary, perform an inventory of physical property descriptions and obtain a land tract picture to identify nonprovider activities and their portion of property taxes and insurance costs.

   B. Ensure that insurance costs included in allowable capital-related costs include only premiums for protection against the loss of tangible assets or for payment of capital-related costs in the event of business interruption (PRM-I, §2806.1). Ensure that the liability portion of auto insurance is not included as a capital-related cost.

   Note: Do not duplicate work done in the Expense (Insurance) section of the audit program.

GAINS/LOSSES ON DISPOSAL OF ASSETS

10. Obtain a schedule of asset disposals that occurred during the cost reporting period and perform the following:

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A. Trace the assets disposed of from the gains or losses computation to Worksheet A-7, column 5. Recompute the amount of gain or loss and compare with the amount reported on the cost report. Ensure that individual gains or losses are allocated properly.

Note: Depreciation expense is adjusted for the current-year portion of gains and losses under $5,000. All other gains and losses are a settlement adjustment. (See 42 CFR §413.134(f) and PRM-I, §132.)

B. Where accelerated depreciation has been claimed, ensure that the computations are in compliance with the recapture provisions of PRM-I, §136.

C. Determine if any assets were sold for a lump-sum sales price. If so, determine that the gain or loss on the sale of each depreciable asset was computed by allocating the lump-sum sales price among all the assets sold on the basis of the relative fair market value of each asset at the time of sale.

Review documentation to support the current fair market value of each asset sold.

D. Determine if there were any exchanges, trade-ins (PRM-I, §104.11), or donations of depreciable assets. If so, determine that gains or losses are not included in the determination of allowable costs.

E. Determine if any assets were demolished or abandoned during the cost reporting period. If so, perform the following steps:

1. Obtain a schedule of these assets.

2. Determine if the aggregate loss (net depreciation adjustment) from all demolition and abandonments during the period is $5,000 or less. Based upon the results of this analysis, the 80 percent test and the replacement test, ascertain the following:

   a. If the loss should be included as an adjustment to allowable cost during the reporting period.

   b. If the loss should be allocated to other cost reporting periods.

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c. If the loss should be capitalized as a deferred charge and amortized.

d. If the loss should be disallowed.

3. Propose an adjustment, if necessary.

INVOLUNTARY CONVERSION

11. Review any changes that occurred in the fixed asset accounts resulting from involuntary conversion losses. A loss resulting from an involuntary conversion includes condemnation, fire, theft or other casualty (PRM-I, §133).

A. Ascertain that allowable involuntary conversion losses:

1. In excess of $5,000 are deferred and amortized over the useful life of the replacement.

2. That are $5,000 or less, are included entirely in allowable cost in the year of the loss.

3. That are not considered as casualty, such as effect on the value of property resulting from a nearby disaster, change of neighborhood and increased risk area rating, are not included in allowable cost.

B. For completely destroyed assets, check with the provider to ascertain the provider's intention with respect to replacement. If the asset will not be replaced, no loss is allowable for losses of $5,000 or less.

C. Ascertain that the insurance coverage reflects a prudent management policy (PRM-I, §2160.5E).

D. Ensure that losses resulting from the provider's failure to obtain proper insurance coverage, and/or not compensated by insurance proceeds where the lack of insurance coverage reflects imprudent management are not included in allowable costs.

E. Where an asset is restored, determine the proper basis to be used for depreciation and determine that the expected useful life is established in accordance with the provider's capitalization policy and AHA guidelines.

F. If the destroyed asset is disposed of by scrapping, determine that income received from salvage is treated

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as a reduction in the amount of the loss.

G. Determine if any gain resulted from insurance proceeds exceeding the amount of the loss. Where the asset is retained, determine that the gain is used first to reduce the amount of restoration cost and that any remaining gain is used to reduce the cost basis of the restored asset.

PARTIAL CASUALTY LOSSES

12. Where a depreciable asset is partially destroyed or damaged as a result of fire or other casualty, a reduction of the cost basis (book value) is assumed to have taken place. Therefore, the cost basis of the asset must be reduced to reflect the amount of the casualty loss regardless of whether the loss is covered by insurance. (See PRM-I, §133.3, for a full description of the method used for calculating the adjustment.)

Perform the following steps:

A. Where an appraisal was made to determine the fair market value of a partially destroyed asset, review documentation to verify the fair market value before and after the casualty.

B. Verify the calculations made in determining the amount of the casualty loss and determine that they comply with PRM-I, §133.3.

C. Ascertain if any insurance proceeds were received. If so, determine that the proceeds were deducted from the amount of the casualty loss to determine the gain or loss.

D. Ascertain that the allowable portion of the casualty loss was recorded as a deferred expense and amortized over the estimated useful life of the restored asset.

E. Where no appraisal is made, review the treatment of the cost of repairs to restore the property to its original state for the following:

1. That the actual cost of repairs is added to the adjusted cost basis of the asset to arrive at the revised cost of the restored asset and capitalized over what is determined to be the remaining useful life of the restored asset.

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2. That when the repairs materially improve or add to the value or utility of the property, or appreciably prolong its useful life, a redetermination of the expected useful life is made.

RETIREMENTS OF ASSETS

13. Retirements - Obtain a schedule of asset retirements that occurred for the cost reporting period under review and perform the following:

A. Determine that if an asset is retired, the provider has not taken any more depreciation expense on the asset. Gain or loss on the retired asset is not computed until disposal.

B. Determine if depreciation for individual assets was computed properly between years prior to and subsequent to entry into the program. Review for the proper calculation of gain or loss.

C. Determine if the asset is being held for standby or emergency use. If so, depreciation may continue to be taken.

D. Determine if the retirement of assets constitutes a termination. If so, perform the following steps:

1. Ascertain if accelerated depreciation was taken on the assets.

2. If accelerated depreciation was taken, obtain the provider's supporting documentation and verify that recapture of depreciation was properly made.

TERMINATED PROVIDERS

14. Where a provider using an accelerated method of depreciation either terminates the program or where the Medicare portion of allowable cost decreases so that cumulatively more depreciation was paid than would have been paid using the straight-line method of depreciation, the excess reimbursement must be recovered. The recovery of amounts paid in excess of straight-line depreciation is applicable to voluntary and involuntary terminations. (See PRM-I, §§132.3 and 132.4.) To ascertain if accelerated depreciation should be recovered, perform the following

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steps:

A. For a provider that terminated the program and disposed of assets during its final cost reporting period or within one year after termination, verify that the correct amount of excess depreciation was recovered.

1. Verify that the recomputed depreciation (straight-line method) applicable to cost reporting periods under the program is distributed proportionately to those periods.

2. Compare the recomputed depreciation for each reporting period to actual depreciation taken in each period. The difference is the excess depreciation to be recovered.

3. Determine that any gain or loss is allocated proportionately to each cost reporting period under the program and is combined with the excess depreciation for that period to determine the net depreciation adjustment (PRM-I, §§132.3 and 132.4).

B. Ascertain if there has been a decrease in the Medicare proportion of allowable costs by performing the steps shown in PRM-I, §136.4. Verify that the correct amount of excess depreciation was recovered.

C. If the provider's termination from the program is due to a change of ownership resulting from a transaction between related parties, accelerated depreciation must be recovered if any of the following four criteria is not met.

1. The termination of the provider agreement is due to a change in ownership of the provider resulting from a transaction between related organizations.

2. The successor provider continues to participate in the Medicare program.

3. Control and extent of the financial interest of the owners of the provider before and after the termination remain the same, that is, the successor owners acquire the same percentage of control or financial investment as the transferrers had.

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4. All assets and liabilities of the terminated provider are transferred to the related successor participating provider.

   Ascertain if the criteria as outlined previously are met by performing the following steps:

   a. Obtain documentation such as agreement of sale and minutes of meetings to ascertain if the change of ownership resulted from a transaction between related parties.

   b. Review the provider agreement of the successor provider to determine if it intends to participate in the Medicare program.

   c. Obtain and review the agreement of sale, minutes of meetings, and financial records to determine if the control and extent of the financial interest of the owners of the provider before and after the termination remain the same.

   d. Determine that all the assets and liabilities of the terminated provider are transferred to the related successor participating provider by reviewing the agreement of sale, minutes of meetings and financial records.

   e. After performing these audit steps, if any of the criteria as outlined is not met, ensure that the accelerated depreciation was properly recovered.

TRANSFERS BETWEEN GOVERNMENT ENTITIES

15. If the provider is a government entity, ascertain whether any assets have been transferred thereto from another government entity. If so, ensure that the provisions of 42 CFR 413.134(h) have been complied with by performing the following audit steps.

   A. Determine if the transfer was:

      1. The result of a sale between government entities.

      2. A donation of facilities.

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3. A transfer made solely to facilitate administration or to reallocate jurisdictional responsibility.

4. A transfer that constituted a taking over, in whole or in part, the function of one government entity by another government entity.

B. If the transfer was a result of a sale between government entities, determine that the basis for depreciation to the purchasing provider is the historical cost incurred in initially acquiring the assets. Also, determine that the historical cost does not exceed the lesser of current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of purchase or fair market value at the time of purchase.

C. If the transfer is the result of a donation of assets from another government entity, determine that the acquiring provider did not assume any functions for which the transferor used the assets and the acquiring provider did not make any payment for the assets in the form of cash, property or services.

D. If the transfer results from Steps A3 and A4, determine if the transferor claimed depreciation under the Medicare program prior to the transfer.

1. If depreciation was claimed, ascertain that the basis for depreciation used by the acquiring provider is the same as the basis used by the transferor prior to the transfer. The acquiring provider may use the same method of depreciation or it may change the method. If the acquiring provider changed its method of depreciation, determine that the change was made in accordance with Medicare principles of reimbursement.

2. If the transferor has not claimed depreciation under the program, determine that the basis used by the acquiring provider is the cost incurred by the transferor in acquiring the asset less depreciation calculated on a straight-line basis over the life of the asset to the time of transfer.

CONSTRUCTION IN PROGRESS

16. Review construction-in-progress expense accounts, either on

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an ongoing basis or at the time of project completion.

A. Ascertain the proper treatment of:

1. Interest during construction (PRM-I, §206);
2. Demolition costs (PRM-I, §132);
3. Repairs and maintenance (PRM-I, §108.2); and
4. Planning costs (architect fees, etc.) (PRM-I, §2154).

B. Analyze increases in the capital account with regard to the capitalization of expenditures previously carried on the financial statements in the prior period as construction in progress to determine:

1. That all costs, including planning costs and demolition costs, are included in asset preparation (capitalized).
2. If construction is performed by a related organization:
   a. The asset values are reduced to the cost incurred by the related organization.
   b. Any allocated costs are included in the new construction.
   c. The allocated costs are supported by adequate documentation.
   d. The allocated costs are in accordance with PRM-I, §104.10.

C. If the provider has undertaken or completed a major expansion of its facilities:

1. Determine that start-up costs have been deferred and are being amortized.
2. Determine that planning costs (architect fees, legal, etc.) have been capitalized as part of the cost of the assets.

PLANNING AND START-UP COSTS - TEFRA

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17. The provider may attempt to treat the operating cost portion (salaries, utility cost, etc.) of properly deferred start-up cost as a capital- related pass-through cost. Determine that planning and start-up costs were properly treated.

Review the desk review files to determine if exceptions were noted on planning and start-up costs. If noted, discuss the exceptions with provider personnel to obtain an explanation for the manner in which these costs were treated.

PURCHASE OF FACILITY AS AN ONGOING OPERATION

18. Where the facility was purchased as an ongoing operation, determine the historical costs of assets by performing the following audit steps:

A. Determine that the cost basis of the depreciable assets does not exceed the lesser of the current reproduction cost adjusted for straight-line depreciation over the life of the assets to the time of the sale or fair market value of the tangible assets purchased.

If the facility went through a change of ownership on or after July 18, 1984, determine the correct acquisition cost of the depreciable assets.

Note: Historical cost limitation is based on the lesser of the allowable acquisition cost of the asset to the owner of record as of July 18, 1984, or the acquisition cost of the asset to the new owner (Deficit Reduction Act, §2314). (See MIM-4, §4508.) In addition, all costs (for example, legal fees, accounting and administrative costs, travel costs, and the cost of feasibility studies attributable to the negotiation or settlement of the sale or purchase of any capital asset referred to previously (by acquisition or merger), for which any payment for any of these items has previously been made under Medicare, are deemed to be unreasonable, and are, therefore, unallowable.

B. Determine if the facility was being operated under the program at the time of sale. If it was, determine that the purchase of the ongoing operation was a bona fide sale. If it is not a bona fide sale, the seller's net book value must be used by the purchaser as the basis for

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depreciation. In such instances, determine that the purchaser recorded the historical cost and accumulated depreciation of the seller that was recognized under the program.

APPRAISALS

There are instances where historical cost records of depreciable fixed assets are not available or are incomplete. In such instances, the principles of reimbursement for provider costs provide that an appraisal of the historical cost of the asset made by a recognized expert will be acceptable for depreciation purposes. Before an appraisal is made, the provider must inform its intermediary of its intent and the reason for the appraisal. The provider must also make the proposed appraisal agreement available to its intermediary. The intermediary will determine if the appraisal firm qualifies as an expert and whether the proposed appraisal meets program requirements.

If accepted, the appraisal must be performed within the time limits specified in the agreement. The appraisal of the historical cost of assets should produce a value approximating the cost of reproducing substantially identical assets of like type, quality and quantity at a price level in a bona fide market as of the date of acquisition.

Also, the appraisal should assist in the construction, reconstruction or revision of accounting records to enable the provider to make proper distribution of depreciation expense in Medicare cost reports. If the appraisal is accepted by the intermediary, the basis for depreciation would be the appraised value of the assets. (See PRM-I, §134.)

NEED FOR APPRAISALS

19. Ascertain if costs of the assets were established with the use of an appraisal because of one or more of the following:

    A. No historical cost records of depreciable fixed assets were maintained.

    B. The provider kept incomplete records of the depreciable fixed assets.

    C. The provider needed to establish an asset's fair market value or depreciated reproduction cost.

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D. More than one asset was purchased for a lump-sum sales price (a group of assets, purchase of an ongoing facility, multi-facility purchases, etc.).

If the provider has not met the requirements of this test, the asset cost and depreciation would not be allowable for Medicare purposes.

APPRAISAL DOCUMENTATION

20. Review the provider's documentation on the need for the appraisals. Ensure that:

A. Intermediary's approval has been obtained.

B. The provider has furnished adequate information supporting the appraisal values, such as:

1. Identity of the appraiser.

2. Letter of acceptance of the appraisal by the intermediary.

3. Copy of the appraisal program and appraisal report.

If the provider has not met the requirements of this test, the asset cost and depreciation would not be allowable for Medicare purposes.

REVIEW APPRAISAL DOCUMENTATION

21. Review the documents involved in the appraisal, such as the appraisal agreement, appraisal program and appraisal report to determine the adequacy of the appraisal and the acceptability of the appraised asset values. In reviewing these documents, perform the following steps:

A. Appraisal Agreement - Review a copy of the appraisal agreement and determine the following:

1. The appraisal date and estimated date of completion;

2. That the appraisal was performed within the time limits specified within the agreement; and

3. That the scope of the appraisal as outlined in the

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proposal was adequate.

B. Appraisal Program - Since the condition of provider asset records varies significantly, an appraisal program could be comprehensive or partial. For instance, a provider may engage an appraisal firm to appraise a part of its facility for which no historical records have been maintained or a provider may need to have an appraisal made on a particular class of assets in a specific identified location. Review the appraisal program and determine that it includes the following:

1. A physical inventory and listing of pertinent data for all applicable assets in used or in standby status, at the appraisal date or report date.

2. The amount assigned to each asset.

3. A classification of each item or unit of property in accordance with the most recent American Hospital Association Chart of Accounts.

4. An estimated useful life for each asset, in accordance with American Hospital Association useful lives (see PRM-I, §104.17).

5. A salvage value for each asset.
6. An appropriate depreciation method for each asset.

7. Calculation of the depreciation provisions for the current reporting period.

8. Calculation of accumulated depreciation using an approved basis from the date of acquisition to the start of the first reporting period in which actual depreciation is first claimed under Medicare.

9. Calculation of square footage for each cost center which identifies all rooms on a floor or within a building if this was not previously done by the provider.

C. Appraisal Report - Review the appraisal report and ascertain that it includes a letter of certification and transmittal and a listing of assets appraised.

1. Determine that the letter of certification and transmittal includes the following:

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a. Name of provider.

b. Location of facilities included in appraisal.

c. Appraised date, date up to which accumulated depreciation was calculated (if other than appraisal date) and period for which current depreciation is calculated.

d. Contents of data supplied to the provider, such as summaries, schedules and plans.

e. A description of the appraisal program. The description should contain information that is not readily apparent in the detailed results (extent of the appraisal, depreciation methods, etc).

f. Policy for determining the value of each asset.

If the provider has not met the requirements of this test, the asset cost and depreciation would not be allowable for Medicare purposes.

APPRAISAL EXPENSE

22. The allowability of appraisal expense depends on the purpose for which the appraisal expense was incurred.

Note: For change of ownership (CHOW) transactions involving assets of hospitals and SNFs, appraisal costs are not allowable if any acquisition costs attributable to the same assets have previously been reimbursed under the Medicare program unless the appraisal costs were not incurred as a result of the CHOW.

To determine the allowability of appraisal expense, perform the following procedures:

A. Discuss the purpose of the appraisal with appropriate provider staff,

B. Review the board of directors minutes authorizing the appraisal, and

C. Review the contract and supporting documentation for the appraisal, for the following purposes:

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1. Determine if the appraisal expense was incurred to establish plant records for Medicare purposes or if the appraisal was for research and other nonpatient departments. This expense could be included in allowable cost if the appraisal was approved by the intermediary.

2. Determine if the appraisal expense was incurred for other business purposes, such as insurance coverage, tax values and financing. If so, ascertain that the expense is included as allowable cost in the administrative and general cost center.

3. Determine if the appraisal expense was incurred to establish values for the sale or anticipated sale of a provider organization. If so, ascertain that these expenses are not included in allowable cost.

4. Ascertain if the appraisal expense incurred was to establish the historical cost of assets that were already adequately reflected in the provider's books, records or tax returns. If so, disallow these costs.

If the provider has not met the requirements of this test, the asset cost and depreciation would not be allowable for Medicare purposes.

DONATED ASSETS - VALUATION

23. Where assets were acquired through donation, and the fair market value was not established as of the date of donation, an appraisal of such fair market value on the date of donation is considered acceptable for depreciation and equity capital purposes. To determine the acceptability of the appraised values, perform the following steps:

A. Where assets other than constructed assets were donated, review the pricing source used to determine the fair market value. From documentation reviewed, determine the acceptability of the appraised value.

B. Where material, labor or services are donated in the construction of an asset, the asset value is the sum of the appraised cost of the material, labor or services actually donated and the incurred cost of the part that was not donated. Review the pricing source used to

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determine the fair market value. From documentation reviewed, determine the acceptability of the appraised value.

DONATED ASSETS - DEPRECIATION EXPENSE

24. Obtain a listing of donated asset acquisitions. Determine if depreciation was claimed on the donated assets. If so, perform the following audit steps:

    A. Determine the basis used for computing depreciation and that it complies with PRM-I, §§104.15 and 104.16.

    B. If cash was paid for the asset by the donor, determine that the amount paid and not the fair market value is used as the historical cost of the asset.

    C. If no cash was paid by the donor, the basis would be the fair market value as of the date of donation. If fair market value is used, determine if an appraisal was made and review the appraisal report. This does not apply if an asset is used under the program at the time of donation. Use net book value.