INTEREST
HOSPITAL AND SKILLED NURSING FACILITY AUDIT PROGRAM (1999)

INTEREST

Exhibit 7 applies to all providers. In addition, for PPS hospitals, see Exhibit 6A.

Regulation Reference: 42 CFR 413.153

OBJECTIVES:

1. To ensure that interest expense is necessary and proper for the operation, maintenance or acquisition of the provider's facilities.
2. To ensure that interest expense is properly classified among capital-related, administrative, nonallowable, and capitalized.
3. To ensure that interest expense is properly reduced by applicable investment income and properly classified as in Objective 2.
4. To ensure that interest included in allowable costs is:
   a. Supported by an agreement that the funds were borrowed.
   b. Identifiable in the provider's accounting records.
   c. Related to the reporting period in which the costs were incurred.
   d. Related to patient care.

OTHER REFERENCES:

PRM-I, §§200 and 2338

Cost Report Forms: Hospital:

HCFA-2552, Worksheet A
HCFA-2552, Worksheet A-7
HCFA-2552, Worksheet A-8
HCFA-2552, Worksheet A-8-1
HCFA-2552, Worksheet G-3

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SCHEDULE OF INDEBTEDNESS AND REVIEW OF INTEREST CLAIMED

1. Prepare or examine a schedule of existing indebtedness identifying pertinent items to ensure that each loan incurred is supported by acceptable evidence or documentation. Ensure that the permanent file contains documentation supporting the schedule.

   A. Review copies of loan agreements, notes, mortgage contracts, etc., for pertinent data applicable to each indebtedness such as:

      1. Date of debt;
      2. Principal amount;
      3. Due date (maturity);
      4. Interest rate;
      5. Method of payment;
      6. Balance at the end of the reporting period;
      7. Amortization schedule;
      8. Collateral (if any); and
      9. Amount of bond premium or discount, if applicable.

   B. Determine the source of borrowing and type of indebtedness such as:

      1. Government bond issue;
      2. Provider or community bond issue;
      3. Notes - From individuals or lending institutions;
      4. Interfund:
         a. Restricted fund; or
         b. Unrestricted fund.

   C. Account for all interest claimed on loans identified in

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Steps 1A and 1B. Prepare or examine a reconciliation of interest expense between the loan schedule and the cost report. This may entail tracing interest expense through the working trial balance and may even require testing the relationship between the working trial balance, general ledger and financial statements.

1. Determine that the interest incurred on each loan is reasonable and stated on an accrual basis, and meets the established rules for being necessary and proper (see PRM-I, §202 ff).

2. On a test basis for the loans, recompute interest expense by reference to the terms of the loan instruments.

3. Obtain or prepare an analysis of interest expense to ensure that interest expense has been properly reclassified to:

   a. Building and fixed equipment;

   b. Movable equipment; and

   c. Administrative and general.

4. Ensure that only interest related to capital assets is included as a pass-through cost.

5. Compare data in the current year's schedule of indebtedness to the prior year's schedule. If this comparison indicates no reductions to the outstanding debt balances, determine the reason the debts are not being repaid.

6. Review any refinancing of long term debt and related borrowing determinations to ensure that they are in accordance with PRM-I, §§202, 215 and 233.

D. Ascertain that the purpose of the indebtedness is necessary, proper and related to patient care (see PRM-I, §202).

E. Retain a copy of the documentation of indebtedness in the permanent file.

LOANS FOR FACILITY OR ASSET ACQUISITIONS

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2. Interest on new loans for facility or other tangible asset acquisitions should be reviewed for excess borrowing over and above the capitalized value allowed by PRM-I, Chapter 1, or DEFRA, §2314. Obtain copies of the purchase contracts, invoices for the acquisitions and related expenses such as professional fees, and loan contracts. Scrutinize these documents to ensure that the conditions in Steps 2A through 2C are met and propose audit adjustments where necessary.

   A. Determine whether the purchase price exceeds the Medicare allowable historical cost or the cost basis, whichever is appropriate. If so, the interest expense on that portion of the loan used to finance the excess is not considered reasonably related to patient care and is not allowable. Also, if any building or other asset covered by the loan is not used for purposes related to patient care, the interest applicable to such assets is not allowable as a cost to patient care.

   B. For the acquisition of facilities where the provider has financed or refinanced for more than the Medicare allowable value of the facility for either operating excess or value to be invested in the activities, the interest expense on that portion of the loan used to finance the excess is not considered to be related to patient care as a capital-related cost. It is necessary to either reclassify this to Administrative and General, capitalize it or disallow it entirely.

   C. For interest expense relating to the acquisition of assets or facilities that have undergone a change of ownership on or after July 18, 1984, ensure that interest expense is limited to the expense incurred for financing total allowable acquisition cost less any applicable equity payments. (See MIM-4, §4508.)

LOANS FOR CONSTRUCTION PURPOSES

3. If funds are borrowed for construction purposes:
   A. During the period of construction, include the following items in a deferred (investment) account:

      1. Interest expense on those funds,

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2. Amortized bond discount and expense on such funds,

3. Reduced by amortization of bond premium on such funds and investment income earned on unused funds during the period.

B. When construction is completed and placed into use for patient care purposes, ensure that the accumulated amount in the deferred (investment) account is capitalized. (See Exhibit 6, Item 16 and PRM-I, §206.

Perform the following tests to determine compliance with these provisions:

C. Review the schedule of indebtedness obtained in Step 1 to determine whether it includes any loans for construction purposes.

D. If the answer to Step 3C is yes, review the construction in progress account to determine whether interest on the identified loans is properly included in the account. If the interest is not properly included, propose an audit adjustment.

BOND PREMIUM OR DISCOUNT AMORTIZATION

4. Where bonds are issued at a premium or discount, ensure that the premium or discount is amortized over the life of the debt (PRM-I, §212.1, should be followed).

LEASED FACILITIES OWNED BY RELATED ORGANIZATIONS

5. Where leased facilities are owned by related parties, the cost of ownership is allowed to the provider in lieu of lease payments. Where leased facilities are owned by related parties, and mortgage interest is paid by the related party, the interest and depreciation expenses are allowable to the provider in lieu of rent expense. Determine that the interest paid is reasonable, necessary and proper. (See Exhibit 8, Step 7.)

FUNDED DEPRECIATION

6. Review provider's funded depreciation account to determine whether the account is maintained in accordance with PRM-I, §226.

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A. Reconcile the amount recorded as having been deposited into the fund with the actual fund deposits. Note any differences and determine whether such differences change any determinations of the amount of allowable interest expense.

Note: Sinking funds would qualify as funded depreciation if they were reserved to pay the principal on the loan; however, funds to pay interest do not qualify for funded depreciation considerations.

B. Examine the deposits to the fund to ensure that the total fund deposits are not in excess of cumulative allowable depreciation expense.

Note: Investment income earned by the funded depreciation and deposited in the funded depreciation account is not taken into account in making this computation.

1. If excess deposits were made, determine that interest income earned by such excess funds was applied as a reduction of interest expense.

2. A valid funding transaction occurs only if the amounts deposited into the funded depreciation account remain on deposit for six months or more. Review deposits to the funded depreciation account for cost reporting periods subsequent to any prior audit to determine whether the deposited funds remained on deposit for six months or more.

   If any deposits did not remain on deposit for at least six months, they cannot be considered valid funding transactions. Investment income earned prior to the elapse of the six-month period will not be offset unless the deposits are actually withdrawn during this period (PRM-II, Section 226.3).

C. Examine the purpose of withdrawals from the funded depreciation account.

Note: Loans to the general fund are considered investments of funded depreciation and are still available; therefore, the investment income would not be offset.

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1. Ensure that the withdrawals were used for the purchase of equipment, improvements of plant or other capital purposes. If withdrawals were made for purposes other than purchase of equipment, improvements of plant or other capital purposes, then interest income attributable to funded depreciation used should be offset against interest expense. This should be offset for all reopenable cost reports as well.

2. Determine whether money was borrowed to make deposits to funded depreciation. If so, interest expense paid by the provider on the money borrowed must be excluded from allowable cost.

D. Review other board-restricted funds, which may be board designated as a funded depreciation account, for possible overfunding of depreciation expense. Investment income earned on excess funded depreciation must be used to offset interest expense.

E. If the provider borrows to purchase fixed assets when funded depreciation is available, perform the following tests:

1. Review the necessity of borrowing computation to determine the extent of borrowing needed, taking the availability of funded depreciation into account.

2. Disallow the interest expense on any excess borrowing.

F. Where the intermediary determines that a borrowing is unnecessary because of the existence of available funded depreciation, and additional deposits have been made to funded depreciation after the occurrence of the unnecessary borrowing, withdrawals made after the date of the additional deposits are deemed to be made on a last-in, first-out basis. (See 42 CFR 413.134((e)(3)(i)(C).)

1. Review the funded depreciation account to ensure that, if this situation has occurred, the provider has complied with this regulation.

2. If the provider has not complied with the

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regulation, propose an audit adjustment.

INVESTMENT INCOME

7. Examine the source of the investment income to determine if the income should be offset against interest expense by reviewing board minutes, bank correspondence and provider records. See PRM-I, §202.2.

   A. Obtain or prepare a summary analysis of investment transactions. Determine and segregate which investments produce income that may affect allowable costs.

   B. Describe each source of fund as to purpose using the following categories:

      1. Related party;

      2. Nonrelated party;

      3. Funded depreciation (not offset);

      4. Sinking funds;

      5. Pension funds (not offset, if qualified pension funds);

      6. Accounts receivable, insurance reserves and contingency reserves; and

      7. Restricted and unrestricted grants and gifts (not offset).

   C. Review investment income from investments to determine proper offset against interest expense.

      Note: Any investment income in excess of interest expense should not be used to offset other operating expenses.

      1. Ascertain that investment income or other income earned by unrestricted funds and commingled with other funds is used to reduce allowable interest expense.

      2. Ascertain that investment income from a pooling of funds that are commingled with other funds has

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been:

a. Applied against allowable interest expense, not to exceed the total interest expense included in allowable costs.

b. Applied to the following cost centers in an amount based on the ratio of interest expense charged to each cost center to total interest expense. See PRM-I, §§202.2, 202.6, 226.4B and 2806.1.G.

i. Administrative and General;

ii. Capital-Related Costs, Building and Fixtures;

iii. Capital-Related Costs, Movable Equipment; and

Note: Items ii and iii would apply to old or new capital as appropriate.

iv. Other Appropriate Cost Centers.

D. If a bond redemption or refunding reserve account other than funded depreciation was maintained, ensure that the related interest income was offset against interest expense unless the funds were from the provider's own funds.

E. Test to ensure that investment income is correctly offset against appropriate capital-related or working capital interest expense. If an investment income offset is required under PRM-I, §202.2 and/or §226.4B, only that portion of investment income that bears the same relationship to total investment income as the portion of capital- related interest expense bears to the total interest expense is offset against capital-related interest expense.

INTEREST ON MEDICARE/MEDICAID OVERPAYMENTS AND UNDERPAYMENTS

8. A. Ensure that the provider has offset the following on Form HCFA-2552, Worksheet A-8,, or Form HCFA-2540, Worksheet A-8,, as a reduction of cost, if applicable:

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1. Interest expense imposed by the intermediary on Medicare & Medicaid overpayments, and

2. Interest expense on borrowings made to repay Medicare & Medicaid overpayments.

B. Ensure that interest paid by the intermediary to the provider on Medicare & Medicaid underpayments was properly handled by performing the following:

1. Determine from intermediary records whether any payment of interest on underpayments was made to the provider during the cost reporting period under audit.

2. If interest on underpayments was paid to the provider, the auditor should advise the provider that such interest should not be included in net investment income for purposes of determining allowable interest expense.

3. Test any provider representations regarding inclusion of such interest income in net investment income.

4. Propose audit adjustments, where necessary.

INTEREST ON LOANS FROM LENDERS RELATED TO THE PROVIDER

9. Review loans from lenders related to the provider through control, ownership or personal relationship to ensure that the interest expense paid on such loans was properly treated. (See PRM-I, §218.) Perform the following tests:

A. Review the schedule of indebtedness obtained in Step 1 to determine whether it includes any loans from related parties.

B. If the answer to Step 9A is yes, ensure that the interest expense is not included in allowable costs unless the exception noted in PRM-I, §218, is met. If the interest is not properly excluded, propose an audit adjustment.

GOVERNMENT BOND ISSUES

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10. Where providers are owned and operated by federal, state or local governments, and the governmental agency issues governmental bonds specifically for provider construction, the interest expense is an allowable provider cost only when the interest is paid by the governmental agency. (See PRM-I, §216.)

    Where the facilities are constructed or acquired with funds raised by the governmental entity by borrowing through the issuance of government bonds (PRM-I, §216):

    A. Ascertain by reference to the board of directors (or appropriate governing body) minutes that the provider entered into a construction contract to be financed by construction bonds issued by the governmental agency.

    B. Where the governmental bond issues are designed to meet construction or acquisition costs for more than one facility, ensure that an appropriate allocation of the interest costs is made to the provider under audit.

    C. Disallow interest costs when funds used to construct or acquire the governmental facilities are obtained from the general purpose funds of the government owner, even though a portion of the general purpose fund is raised through bond issue(s).

    D. Ascertain that the interest expense on the bonds is paid by the governmental agency and not by the provider. Perform the following tests:

        1. Review the schedule of indebtedness to ensure that the interest is **not** paid by the provider.

        2. Review the journal entries recording the interest expense transfer from the governmental agency.

        3. Obtain a certification from the governmental agency, or inspect the governmental agency's records regarding the payment of interest.

        4. Review the bond indenture to confirm that it relates to the construction of the provider's facilities.

        5. Review the receipt of the bond proceeds from the governmental agency and their use to fund the construction.

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6. Propose audit adjustments, where necessary.

E. Where bonds are issued at a premium or discount, ensure that the premium or discount is amortized over the life of the debt. Propose audit adjustments, where necessary.

RECALL OF BONDS BEFORE MATURITY

11. This section applies to a recall of debt before scheduled maturity without the issuance of new debt. Costs incident to the recall of debt before the date of maturity are considered debt cancellation costs and are allowable to the extent they are reasonable. (See PRM-I, §215.)

A. Review the board of directors minutes and financial statements to determine if any action was taken applicable to recall of debt before maturity.

B. Where a recall of debt has taken place, perform the following tests:

1. Recompute the make-up of debt cancellation costs - that is, bond recall penalties, unamortized bond discounts and expenses, and legal and accounting fees.

2. Determine that debt cancellation cost was reduced by any unamortized bond premium.

3. Determine that any cancellation costs attributable to years before the provider entered the program were not included in reimbursable costs.

4. Test the reasonableness of the debt cancellation costs by determining the following:

a. The overall financial implications of the recall on the provider, and

b. That the provider obtained any necessary approvals, if required by authorized planning agencies.

Where these tests reveal deficiencies, propose necessary audit adjustments.

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C. Determine whether the costs incident to debt cancellation plus the actual cost incurred on the bond during the provider's accounting period were LESS or MORE than the amount of interest expense and amortization expense that would have been allowable in that period had the indebtedness not been canceled.

1. If LESS, the cost of debt cancellation, to the extent reasonable, is allowable in the year incurred. Verify the accuracy of debt cancellation costs claimed.

2. If MORE, the maximum allowable cost in that period is the total amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been canceled. Determine the accuracy of the calculation of maximum allowable costs.

3. The full amount will be allowable in the period incurred when the debt cancellation costs are less than 50 percent of the amount of interest expense and amortization expense that would have been allowable in that period had the indebtedness not been canceled. If the full amount of debt cancellation cost is claimed, determine that the 50 percent requirement has been met and verify the accuracy of the total amount claimed.

ADVANCE REFUNDING OF DEBT

12. Determine if an advanced refunding of debt occurred, by reviewing the board minutes and footnotes to the financial statements, and the cost report questionnaire (Form HCFA-339). (Refer to PRM-I, §233.)
If advanced refunding of debt occurred, perform the following:

A. Prudency determination:

1. Determine and document the reason(s) for the refinancing. (See PRM-I, §233.4).

2. If the advance refunding took place for reasons other than achieving a lower interest rate, verify the existence of the compelling factors.

3. If the purpose of the advance refunding was to

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lower the interest rate, obtain from the hospital and verify the comparison of the total net aggregate allowable costs (described in PRM-I, §233.3) incurred for all cost reporting periods related to the advance refunding to the total net aggregate cost that would have been allowed had the refunding not occurred. Use the following steps to perform this verification.

a. Refunded Debt (old debt)

i. Analyze future interest expense. Review the expense, by bond year, for the period from the date of advance refunding to the last maturity of the bonds. Note that the hospital may have already expensed some of the interest applicable to the year the advance refunding occurred. The amount on the schedule will be reduced by the amount expensed. This information can usually be obtained from the debt service schedule included in the official statement.

ii. Convert interest expense from bond year to fiscal year, if different (accruals).

iii. Analyze, by fiscal year, the unamortized bond issuance costs and underwriter discount.

iv. Reconcile remaining costs plus current year expense to prior years' ending balance in the audited financial statements.

v. Calculate any premiums or penalties to be paid for the early extinguishment of debt.

b. Refunding debt (new debt)

i. Analyze the total interest expense to be paid on the new debt.

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ii. Verify the calculation of the bond discount (not underwriter's discount). This is usually a percentage of the bonds issued and will be indicated on the cover sheet of the official statement.

iii. Verify the debt issuance costs. These include legal fees, accounting fees, printing, etc., and will be supported by vendor's invoices.

iv. Review the source/use funds statement in the official statement. This schedule will indicate if any additional borrowing occurred for purposes other than refinancing.

v. Review the source/use funds statement and footnotes to determine the distributions to the various bond funds (escrow fund, debt service reserve fund, etc.) and apply the funded depreciation instructions in PRM-I, §226 to these funds. It is possible that some of the funds may be considered as funded depreciation accounts.

c. Escrow fund

Determine by year, the income to be generated by the escrow fund. Usually there is an income analysis prepared by the underwriter and available as part of the bond documents. Sometimes the analysis may be illustrated by year. Other times, only the information applicable to the securities purchased is available. In the instances where minimal information is furnished, annual income schedules will have to be prepared by the auditor.

B. Allowable cost verification

1. If Exhibit 13, Steps A1 through A3, indicates that the advance refunding does not satisfy the conditions of PRM-I, §233.4, verify that the costs for the current year are allowable to the extent that

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the cumulative costs under the advance refunding do not exceed the total costs that would have been incurred if the old bonds had not been refunded.

2. If the transaction was determined to be prudent, verify that the expenses and revenues associated with the advance refunding debt are allowed as follows (refer to PRM-I, §233.3):

   a. Interest expense on the refunded debt is allowable on an annual basis as paid or accrued, whether by the hospital or by a trust (refer to PRM-I, §2305(f)).

   b. Interest expense on the refunding debt is allowable as paid or accrued. The investment income derived from the investment of the proceeds of the refunding debt must be used to offset interest expense in accordance with PRM-I, §202.2, whether this investment income is earned by the hospital directly or through a trust.

   Note: Gains or losses on advanced refunding computed in accordance with GAAP are not allowable for Medicare.

   c. Debt issue costs on the refunding debt must be amortized over the life of the refunding debt from the date the debt is incurred to scheduled maturity of the debt.

   d. Debt cancellation costs on the refunded debt are allowable as indicated below:

      i. Redemption expenses and any other miscellaneous expenses (such as advertising costs to inform the bond holders of the refunded debt of an early call of the bonds) are allowed as paid or accrued (subject to PRM-I, §2305);

      ii. Annual authority and trustee fees are allowed as paid or accrued (subject to PRM-I, §2305);

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	iii. Call premiums or penalties are allowable in the period(s) the holders of the refunded debt receive principal payment.		
	e. Unamortized discounts or premiums and debt issue costs of the refunded debt must be amortized over the period from the issue date of the refunding debt to the date the holders of the refunded debt will receive the principal payment.		