Approved 1-19-84
Date

MINUTES OF THE HOUSE COMMITTEE ON PUBLIC HEALTH AND WELFARE.

The meeting was called to order by Marvin Littlejohn
Chairperson
at

1:30 ~~a.m.~~/p.m. on January 16, 1984 in room 423-S of the Capitol.

All members were present except:

Committee staff present:

Emalene Correll, Research
Bill Wolff, Research
Norm Furse, Revisor
Sue Hill, Secretary to Committee

Conferees appearing before the committee:

Trudy Racine, Post Audit, senior Auditor
on:- Adult Care Homes in Kansas, Property-Related Costs & Practices.

See (Attachment No. 1.) for guest register.

Chairman called meeting to order and introduced to committee Ms. Trudy Racine, senior Auditor of Post Audit. Ms. Racine then began her very comprehensive report on Post Audit/Property Costs-Adult Care Homes in Kansas. Some of the things the Special Services Committee had seen guided them to ask for further audits, and this report today results from such audit.

Many questions from committee members evolved from the audit report by Ms. Racine, ranging from the levels of percentiles set by SRS; are they and why are percentiles levels not used, averaged? Rewards to those Care Homes who are able to hold down their costs; tax advantages cause of most of sale of Home Care property; why are Non Profit Homes more expensive to run than Profit Homes; why is there, and how do we deal with so much Out-Of-State investing in these homes; and many many other probing questions.

What can be done, and the controls that can be put in place are shown on the bottom of Page 12, and through page 15 of the brown booklet "Performance Audit Report, January, 1984", that is shown as (Attachment No. 2.)

Rs. Racine also used (Attachment No. 3.) as her outline for her presentation.

Chairman adjourned the meeting at 2:45 p.m.

Date: Jan 16th, '84

GUEST REGISTER

HOUSE

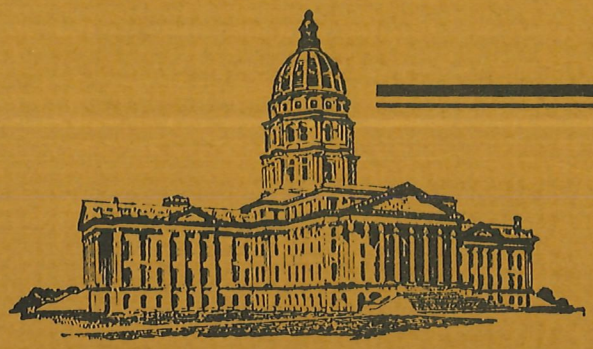
PLEASE PRINT

PUBLIC HEALTH AND WELFARE

NAME	ORGANIZATION	ADDRESS
Cynthia Lash	Post Audit	
John Schneider	SRS	
Don Look	SRS	
Jack Gumb	SRS	
Dick Hummel	Ks. Healthcare Coop	Topeka
Stu Entz	KAHA	Topeka
Elizabeth Taylor	KDHA	Topeka
Lynell E King	Ks State Nurse's Assn	"
KEITH R LANDIS	CHRISTIAN SCIENCE COMMITTEE ON PUBLICATION FOR KANSAS	"
Marilyn Bradt	KINH	Lawrence
Stan Stenersen	Post Audit	Topeka
Ken Schatterman	Ks Pharmacists Assoc.	"
Jon Hollowell	KDH&E	"
Del Gates	HRS	
Sherm Parks, Jr	KCA	"

Attm. #1.
1-16-1984

1-16-4
attm #2



PERFORMANCE AUDIT REPORT

Adult Care Homes in Kansas—
Property Costs

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
January 1984

Attm. #2
1-16-1984

Legislative Post Audit Committee

Legislative Division of Post Audit

THE LEGISLATIVE POST Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about $3 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

As a guide to all their work, the auditors use the audit standards set forth by the U.S. General Accounting Office and endorsed by the American Institute of Certified Public Accountants. These standards were also adopted by the Legislative Post Audit Committee.

The Legislative Post Audit Committee is a bipartisan committee comprising five senators and five representatives. Of the Senate members, three are appointed by the Senate President and two are appointed by the Minority Leader. Of the Representatives, three are appointed by the Speaker of the House and two are appointed by the Minority Leader.

Audits are performed at the direction of the Legislative Post Audit Committee. Legislators or committees should make their requests for performance audits through the Chairman or any other member of the Committee.

LEGISLATIVE POST AUDIT COMMITTEE

Representative Robert H. Miller, Chairman
Representative William W. Bunten
Representative Joseph Hoagland
Representative Ruth Luzzati
Representative Bill Wisdom

Senator Paul Hess, Vice-Chairman
Senator Neil H. Arasmith
Senator Ross O. Doyen
Senator Tom Rehorn
Senator Joe Warren

LEGISLATIVE DIVISION OF POST AUDIT

Suite 301, Mills Building
Topeka, Kansas 66612
(913) 296-3792

PERFORMANCE AUDIT REPORT

ADULT CARE HOMES IN KANSAS: PROPERTY-RELATED COSTS AND PRACTICES

OBTAINING AUDIT INFORMATION

This audit was conducted by three members of the Division's staff: Trudy Racine, senior auditor; and Tom Vittitow and Cynthia Lash, auditors. Assistance was provided by the Division's electronic data processing staff. Ms. Racine was the project leader. If you need any additional information about the audit's findings, please contact Ms. Racine at the Division's offices.

TABLE OF CONTENTS

ADULT CARE HOMES IN KANSAS: PROPERTY-RELATED COSTS AND PRACTICES

SUMMARY OF LEGISLATIVE POST AUDIT'S FINDINGS

This performance audit is one of a series examining adult care home costs in Kansas. These costs are divided into four areas: property, health care, room and board, and administration. This particular audit examines adult care home ownership and the property costs and practices associated with it.

This audit, like the others in the series, also focuses on the State's Medicaid reimbursement system. Under the Medicaid program, the State supports patients in adult care homes who cannot pay their own cost of care. Containing costs while at the same time ensuring adequate care is a major concern behind the request for this series of audits.

This audit contains some preliminary conclusions about the relationship between the reimbursement system and the general financial health of adult care homes. Kansas' reimbursement rate for all kinds of costs combined appears to be lower than the rate in most other states. Future audits in this series still need to examine other aspects of those rates, but from the analysis so far it does not appear that current reimbursement rates preclude Kansas nursing homes from being financially healthy. The greatest opportunity for financial health comes from skillful financial management, including the advantages of the cash flow available through the Medicaid system. This report discusses the various ways in which adult care homes return money to their owners.

The audit's more specific findings about property-related costs and reimbursement are as follows:

Main Findings About Property-Related Costs and Practices

1. **For-profit homes have higher property-related costs than non-profit homes do.** Most of the difference is in mortgage and lease expenses and in taxes. On the average, for-profit homes paid $.70 more per patient day in mortgage and lease expenses than non-profit homes did, and they paid $.24 more per patient day in taxes.

2. **Changes of ownership are having a substantial effect on the composition of the adult care home industry.** Between March 1982 and November 1983, 58 of the State's approximately 300 intermediate care facilities changed "providers"--that is, changed the legal entity that provides the service and receives the Medicaid reimbursement. Most of the new providers were from outside Kansas. Before the change, 47 of the 58 homes had in-State providers. After the change, only 20 had in-State providers. Most of the new providers also operated a chain of two or more homes. Before the

change, 28 of the 58 homes were part of a for-profit chain of two or more homes; afterwards, 48 were.

3. **Changes of ownership are having a substantial effect on property-related costs and Medicaid reimbursement rates.** When homes change providers, mortgage or lease costs usually increase. For the 58 homes that changed hands, property costs increased an average of 47 percent. Property cost increases are passed along to Medicaid reimbursement rates in several ways. In some cases, reimbursement rates rise immediately. For the 58 homes that changed hands, for example, the State could pay as much as $650,000 in additional property reimbursement during fiscal year 1984. More important than the immediate effect, however, is the effect on reimbursement in later years. Reimbursement rates are based on actual costs, and when costs rise, subsequent reimbursement rates will rise as well. The change in these 58 homes alone would raise the maximum reimbursement rate for the State's intermediate care facilities from the old limit of $6.00 per patient day to $7.41 per day, an increase of 23.5 percent. As adult care homes continue to change hands, the rates will continue to rise.

Main Findings About the Reimbursement System

1. **Existing controls in the State's reimbursement system will temper the rise in property-related reimbursement but will not stop it.** The reimbursement system has a number of controls over property-related reimbursement. For example, it disallows increases based on the sale of a home that has already been sold within the past three years, and it has a cap on the reimbursement rate. Nevertheless, the turnover in homes will continue to raise property-related costs, and this in turn will raise the property reimbursement level.

2. **The existing system may encourage owners to sell homes rather than to keep them for longer periods.** Adult care homes offer a number of short-term investment advantages, and the current system may reinforce these short-term advantages more than it encourages long-term retention. To address this matter, and to offset the differences in reimbursement rates for similar facilities when one is sold and the other is not, substantially different approaches to reimbursement in the property area may be needed.

3. **Kansas can also improve its ability to monitor what is taking place in the property-related practices of adult care homes.** The improvements include increased ability to track the history of a home in State records regardless of changes in providers, more thorough and consistent information about sales and lease agreements, and better information about profitability.

ADULT CARE HOMES IN KANSAS

PROPERTY-RELATED COSTS AND PRACTICES

This performance audit is one of a series of reports examining adult care home costs in Kansas. These audits were requested by the Special Committee on Special Care Services and by the Legislative Post Audit Committee.

At the center of this series of audits is the State's Medicaid reimbursement system. Under the Medicaid program, the State supports patients in adult care homes who cannot pay their own cost of care. In fiscal year 1983, approximately $85.5 million was spent for such support. Since fiscal year 1976, costs have risen $44.5 million, an increase of 108 percent.

The State's Medicaid reimbursement system is an attempt to balance several different goals. Through the system, the State tries to ensure a reasonable level of care while at the same time encouraging efficiency and keeping costs in line. In recent years, the situation in Kansas and other states has been complicated by considerable turnover in the ownership of adult care homes. Ownership by out-of-State interests has increased, and concern has been voiced that increasing amounts of Medicaid reimbursement are going for mortgage and lease costs and for administrative expenses--items that may have only a limited relationship to the care that residents receive.

All of these concerns were motivating factors behind the request for this series of audits. This particular report provides information about several of the concerns. In particular, this audit does the following:

1. It provides an overview of the reimbursement system and the place of property reimbursement within the system.
2. It examines the ways in which an adult care home's revenues, financial management practices, tax structure, and other financial characteristics contribute to making it a potentially profitable business venture.
3. It examines trends in ownership, leasing, and other property-related characteristics of adult care homes and the effect of those trends on property-related costs.
4. It assesses the State's current controls over reimbursement for property-related costs of adult care homes.

An Overview of the Reimbursement System and Adult Care Home Profitability

The Medicaid program supports patients in adult care homes who cannot pay their own cost of care. It reimburses adult care homes on the basis of their costs in four areas: property, health care, room and board, and administration. Each year, homes report their costs to the Department of Social and Rehabili-

tation Services, which uses the reported costs to set reimbursement rates for the coming year.

The process for setting reimbursement rates is a complicated one and is described at greater length in Appendix A. One important part of the process is the use of various measures to contain costs. These cost controls include the following:

1. **Exclusion of programs and services not applicable to Medicaid patients.** An example of such programs would be costs associated with operating a beauty shop within the home.

2. **Restrictions on minimum occupancy rates.** To protect the State from reimbursing costs that are too high because occupancy rates are low, allowable patient-related costs are subject to a minimum occupancy provision of 85 percent.

3. **Limits on reimbursement rates.** Allowable costs are reimbursed only up to certain percentile limits in the four cost centers and overall. The limits are based on the costs in all homes and are as follows:

Property	85th percentile of homes' costs
Health Care	90th percentile of homes' costs
Room and Board	90th percentile of homes' costs
Administration	75th percentile of homes' costs
Overall Costs	75th percentile of homes' total costs

4. **Other controls in specific cost centers.** In the property area, for example, there are restrictions to limit reimbursement if a home is sold again within three years after it has been purchased.

5. **Efficiency factor payments.** In certain categories, the State pays a bonus to homes with low costs. This payment is a cost control measure because it encourages homes to operate efficiently.

At the end of the process, a reimbursement rate is set for each home. Because of the cost controls, a home with very high costs probably will not be able to recover all of its costs. On the other hand, homes with relatively low costs will receive full reimbursement, and homes with the lowest costs can receive some additional money in the form of an efficiency payment.

The table on the next page shows the historical costs reported by 258 intermediate care homes as of June 1, 1983. (In all, there are about 300 intermediate care homes, but about 40 did not have historical costs because of recent changes in ownership.) The table also shows the reimbursement limits established by the Department of Social and Rehabilitation Services. These limits were in effect from October 1, 1982 to September 30, 1983.

	Average Historical Cost per Patient Day	Reimbursement Limit per Patient Day
Total Cost	$ 26.35	$ 28.16
Administration	2.96	3.35
Property	4.90	6.00
Room and Board	7.49	9.75
Health Care	11.01	13.47

Compared With Reimbursement Rates in Other States, Kansas' Rate Is Low

In March 1983, the Center for Policy Research of the National Governors' Association issued a study comparing reimbursement rates among the states. The study showed that Kansas' reimbursement rates are lower than most other states. In 1981, the last year for which national information was available, the average reimbursement rate for intermediate care facilities was $33.49 per patient day. Kansas, at $22.16 per day, ranked 45th among the 45 states responding. For skilled nursing facilities, its reimbursement rate of $27.80 ranked 43rd among the 45 states reporting; the national average was $41.71.

Kansas' ranking does not necessarily mean that its cost controls are more effective than those of other states or that its reimbursement rates are out of line. Reimbursement rates are affected by many other factors such as past rates, cost of living, level of care provided, property values, and the like. Kansas' controls are not necessarily more restrictive than those of other states, either. Its percentile limits, for example, are considerably higher than those used in some other states. Nevertheless, the fact remains that total reimbursement rates in Kansas for 1981 were lower than most states.

Kansas' Reimbursement Rates Do Not Appear to Preclude Adult Care Homes from Being Financially Healthy

The adult care home industry in Kansas has raised the issue of low reimbursement rates as one that threatens the financial health of the industry. In this part of the series of audits, the auditors spent considerable time analyzing a sample of 25 intermediate care homes, including 11 that had recently been sold, to determine ways in which a nursing home's income, financial management practices, tax structure, and other factors can contribute to making it a profitable business venture. They were especially concerned about whether current reimbursement rates precluded nursing homes from being financially healthy. At this point, the conclusions must be somewhat tentative, because more remains to be done in subsequent audits to assess costs, services provided, and rates themselves. Nevertheless, the property-related audit appears to be the best place to discuss many of these issues.

Reimbursement rates can affect a home's financial health, but high reimbursement rates do not appear to guarantee financial success, and low reimbursement rates do not appear to preclude a home from being profitable. The auditors found that the greatest opportunity for financial gain comes from skillful financial management, including the advantages of the cash flow

available through the Medicaid system. Although Kansas' low reimbursement rates would make it difficult for a home to turn much of a profit simply by providing services to Medicaid patients and being reimbursed for them, adult care homes have many other ways to obtain financial rewards.

The auditors identified eight main factors to be considered in evaluating the financial desirability of owning or operating an adult care home. These factors are summarized below. Appendix B discusses each factor in more detail and presents additional information about what the auditors found regarding homes in Kansas.

Net income. This is the amount by which revenues exceed expenses, and it is the most common measure of profit. The auditors reviewed the cost reports of the 25 homes to determine their net income. There were wide variations in net income, ranging from losses of $100,000 or more to incomes nearing $200,000.

On its own, however, net income does not provide a clear picture of the financial gain to a home's owner. This is because expenses against which revenues are subtracted can include money coming to the owner in the form of compensation, and because financial rewards can also be obtained in the other ways described below.

Cash flow. Under the reimbursement system, owners are compensated for depreciation. Depreciation is not an expense in the same way as salaries or utilities, however, and this portion of the reimbursement can thus be used for other purposes. In the homes they reviewed, the auditors found that many were able to distribute part of their cash flow into other interests.

Amount of owner investment. The less an owner has to invest of his or her own money in a home, the higher the rate of return from a given level of profit. The auditors were not always able to identify clearly the amount of owner investment in the homes they reviewed, but it is clear from recent purchases that it is possible to obtain highly leveraged financing (financing with other people's money), either through private-sector lenders or through industrial revenue bonds.

Withdrawal of cash from the business. Owners can withdraw cash from the business in several ways. They can pay themselves or their spouse; they can loan themselves money; they can pay dividends to stockholders; or, if they own a chain of homes, they can transfer money to the central office. The auditors found examples of all these practices in the homes they examined.

Tax advantages. There are many tax advantages available to adult care home owners. These include tax deductions for interest on loans, for payment of other taxes, and for depreciation of property, to name only a few. Investment tax credit for purchase of new equipment is also available. Revenues received from Medicaid reimbursement of property costs, especially in early years, can be shielded largely or completely from taxation, producing income that can be used to invest in other ventures. The attractiveness of the tax write-offs has led to the creation of limited partnerships for the purpose of investing in nursing homes.

Selling and capital gains. Owners can also make a profit by selling a home for more than they paid for it. Because this profit is a capital gain, it is taxed at capital gains rates rather than at higher ordinary income rates. Selling adult care homes also drives up reimbursement rates, which can increase cash flow, provide more capital for use outside the business, and produce greater tax advantages. The Department of Social and Rehabilitation Services has established controls to hold down the frequency with which a home's sale can affect the reimbursement level, but the selling and reselling of homes even within the Department's guidelines will increase the reimbursement rate.

Leasing and refinancing. Some owners may find advantages in leasing their homes to others as an alternative to selling the property. This allows the owner to continue to receive any tax advantages from the home as well as to retain the value of the asset. Some owners may participate in sale/lease-back arrangements that are not arm's-length transactions. Kansas does not reimburse providers for such arrangements, but it is often difficult to determine whether the lease arrangement is indeed at arm's length. Refinancing offers an owner the chance to withdraw his or her equity and to gain the tax advantage of higher interest payments.

Percentage of Medicaid patients. While Medicaid reimbursement provides revenue for an adult care home, it is an inferior souce of revenue to that generated by private-paying patients. At best, Medicaid reimbursement will cover only costs and a small reward for an efficiency factor, while private-paying patients pay at a generally higher rate. The higher the percentage of private-paying patients, the greater the net income for the home is likely to be. It should be noted, however, that Medicaid patients in Kansas are a larger percentage of the residents in for-profit homes than in non-profit homes (52 percent in for-profit homes, 40 percent in non-profit homes).

In their review of nursing homes, the auditors found examples of all eight of these factors at work. The homes they reviewed presented a diverse picture of profit and loss, (see the examples on the following page), and it is likely that a review of even more homes would present additional examples of the same diversity. Profit or loss in the nursing home industry, in short, varies markedly between homes and appears to be related heavily to skillful financial management. Medicaid reimbursement rates in Kansas by themselves do not appear to preclude owners from obtaining financial rewards from their businesses. However, selling at the appropriate time may well hold the prospect of greater financial rewards.

Providers do not necessarily sell because their homes have become unprofitable. Of the 11 homes that were sold, eight had a positive net income, and six had a positive cash flow. The eight with positive income figures provided an average of $29,963 in cash to their owners, including compensation. The three facilities which had net losses were all leased facilities, and their providers had been in business for less than four years. The eight profitable homes had been in business longer. Two had been in business for five to six years, and the remaining three for approximately 12 years.

The auditors contacted seven prior owners of these facilities to inquire about their reasons for selling. Between them, these owners had been involved

in 32 Kansas nursing homes. Reasons they cited for selling involved the relative profitability of staying in business when compared to the advantages of selling, as follows:

--restrictive limits on allowable costs, both within cost centers and overall
--no return on equity
--inability to buy out a partners' share
--low reimbursement rates

Several also mentioned that they had difficulty complying with the Department of Health and Environment's regulations covering health care while remaining within the cost limitations established by the Department of Social and Rehabilitation Services.

ADULT CARE HOME FINANCES—SOME EXAMPLES

Example 1: This home was financed with $700,000 in industrial revenue bonds in 1975. By 1977, when the auditors picked up the financial history, the two owners had an equity of about $40,000. Between January 1977 and June 1982, the two owners reported a net loss for the facility of nearly $70,000. In that five-year period, the two worked full-time and received compensation and dividends totaling about $283,000. When they sold the home in June 1982, they received an apparent capital gain of nearly $320,000.

Example 2: This home was financed with $675,000 in industrial revenue bonds in 1976. The owners' initial investment was $50,000. Between 1976 and April 1982, the two owners reported a net loss for the facility of nearly $13,000. During that time, one owner worked full time and the other one-fifth time, and they received about $180,000 in compensation and dividends. When they sold the home in April 1982, their equity had decreased to $2,500, and the mortgage had decreased to $623,000. They received an apparent capital gain of about $144,000 from the sale.

Example 3: This home was purchased in August 1978 for $800,000, with an apparent initial investment by the owners of $5,000. Between 1978 and April 1982, the owners reported a net income for the facility of $60,000. One owner worked full time, the other three-fourths time, and they received a total of nearly $180,000 in compensation and loans during the period. They sold the home for $1.2 million, realizing nearly $500,000 in capital gains.

Example 4: This facility had a net loss of nearly $100,000 in 1982. In addition, an increase in outstanding debts and current liabilities resulted in a negative operations cash flow of $121,000. The owner invested an additional $116,500 which decreased the cash flow deficit to less than $5,000 and finished the year with a negative equity of about $142,000. This facility had an unusually low occupancy rate of 67 percent and a high percentage of Medicaid patients (69 percent), combined with costs which were above the maximum reimbursement rate in two cost centers and overall.

Example 5: This non-profit facility had a net loss of more than $25,000 in 1982. Liabilities exceeded the $150,000 cash flow from depreciation, resulting in a negative operations cash flow of $42,000. No transfers, withdrawals or additional investments were made, and the facility ended the year with equity of $953,000. Although this facility also had a low occupancy rate of 76 percent, and was above the reimbursement limits in three cost centers and overall, its losses may have been minimized by its low Medicaid occupancy of approximately three percent.

An Overview of Property Practices of Adult Care Homes

The remainder of this audit concentrates on the property cost center. Property costs include such items as utilities and maintenance, but the main item relates to compensation for the cost of the building itself. With regard to building costs, homes in Kansas can be divided into four categories:

1. Homes with a mortgage.
2. Homes with a lease or other rental agreement.
3. Homes with a combination of the two.
4. Homes with neither a mortgage or lease. In general, these homes are owned outright by those who provide the care services.

To examine this cost center, the auditors analyzed historical cost records of 258 intermediate care homes. They classified the homes into the four categories as follows:

Homes with a mortgage:	**149**
Homes with a lease or other rental agreement:	**37**
Homes with a combination of the two:	**14**
Homes with neither a mortgage or lease:	**58**

Those who operate these homes can also be classified in a number of ways. Some operate only one home; some operate many. Some operate for profit; others do not. In recent years, many adult care homes have changed hands, and concern has grown about the composition of those who are providing services. To provide information that would address that concern, the auditors established the following classifications for homes:

1. For-profit homes
   a. Non-chain homes (one home only)
   b. Small chains (2-5 homes)
   c. Large chains (6 homes or more)
2. Non-profit homes
   a. Government homes
   b. Church homes
   c. Other (non-profit entities independent of a church or governmental unit)

Most homes can be classified without difficulty, but some present problems because of complicated patterns of ownership and operation. In some cases, one corporation may own the home but another may provide the services. In others, a person may own one home outright but be a stockholder in a corporation that owns a second home. The auditors decided to classify the 258 intermediate care homes on the basis of the **provider**--the legal entity that provided the services and received the Medicaid reimbursement. Any classification scheme will be imperfect, but this one provides at least a relatively accurate picture of the situation:

For-profit homes:	156
Non-chain (one home only)	77
Small chains (2-5 homes)	45
Large chains (6 homes or more)	34
Non-profit homes:	102
Government	25
Church	27
Other	50

The table below shows each of those same classifications of providers in relationship to whether their homes have a mortgage, a lease, a combination of the two, or neither of the two. The table shows that in both the for-profit and non-profit groups, the majority of homes reported mortgage expenses. Leases and combinations were more prevalent in the for-profit group, and homes for which no mortgage or lease expense was reported were much more common in the non-profit group.

	Total	Mortgage	Lease	Combination	Neither
For-Profit Homes:	156	92	30	14	20
Non-chain	77	46	15	5	11
Small chain	45	25	15	3	2
Large chain	34	21	0	6	7
Non-Profit Homes:	102	57	7	0	38
Government	25	8	0	0	17
Church	27	15	2	0	10
Other	50	34	5	0	11

The numbers above provide a general picture of property practices in the Kansas nursing home industry, but they do not provide any indications of recent trends or developments. To determine whether the picture has been changing, the auditors examined 58 intermediate care facilities that reported a change in provider between March 1982 and November 1983. This group represented the most recent homes to have changed hands in the State. The review showed the following:

1. **There is a clear trend from in-State to out-of-State ownership.**

Before the change, here is how the providers were classified...		After the change, here is how the providers were classified...	
In-State, for-profit:	44	In-State, for-profit:	19
In-State, non-profit	3	In-State, non-profit:	1
Out-of-State, for-profit:	8	Out-of-State, for-profit:	36
Out-of-State, non-profit:	3	Out-of-State, non-profit	2

2. **Chain ownership is growing.**

Before the change, here is how the for-profit providers were classified...		After the change, here is how the for-profit providers were classified...	
Non-chain:	24	Non-chain:	7
Small chain:	14	Small chain:	27
Large chain:	14	Large chain:	21

3. **Lease arrangements are increasing.**

Before the change, here is how for-profit and non-profit providers were classified...		After the change, here is how for-profit and non-profit providers were classified...	
Mortgage:	34	Mortgage:	33
Lease:	13	Lease:	25
Combination:	9	Combination:	0
Neither:	2	Neither:	0

An Overview of Property Costs

The average property cost for the 258 intermediate care facilities was $4.87 per patient day. This average cost was broken down as follows:

Asset Costs: includes taxes, interest on mortgage, rent or lease expense, amortization of improvements, and depreciation.	$2.52
Operating Costs: includes utilities (except telephone), maintenance and repairs, and supplies for maintenance and repairs.	1.88
Property-related Personnel Costs: includes salaries and benefits for maintenance personnel, and owner compensation for maintenance related work.	.39
Other Costs: miscellaneous property-related items	.08
Total	$4.87

The auditors' preliminary work showed considerable differences between property costs for non-profit and for-profit homes. For-profit homes had total average costs of $5.04 per patient day, while non-profit homes had total average costs of $4.62 per patient day. Tests on this information showed that the difference was statistically significant; that is, there was little possibility that the difference occurred simply by chance. The auditors thus looked further to see what was causing the difference.

Most of the Difference in Property Costs Is the Result of Differences in Asset Costs

The property categories of operating costs, property-related personnel costs, and other costs do not account for much of the variation between for-profit and non-profit homes in their property costs. Appendix C discusses the auditors' findings regarding operating, personnel, and other costs. Although costs in these categories differ somewhat between types of homes, they do not play a large role in shifting the total difference in property costs.

Most of the difference between for-profit and non-profit homes is in the asset costs. The asset costs for the homes were as follows:

Average asset costs for all homes:	$2.52
Average asset cost for-profit homes:	$2.82
Average asset cost for non-profit homes:	$2.07

Homes which reported mortgage expense contributes most to the difference between for-profit and non-profit homes:

For-Profit Asset Costs		**Non-Profit Asset Costs**	
Mortgage	$3.18	Mortgage	$2.47
Lease	$3.04	Lease	$3.05
Combination	$2.50	Combination	N/A
Neither	$1.06	Neither	$1.28

Comparing costs of the various types of for-profit and non-profit providers showed that asset costs are the lowest for government-related facilities, and highest for small chains:

For-Profit Asset Costs		**Non-Profit Asset Costs**	
Non-Chain	$2.77	Government	$1.48
Small Chain	$3.08	Church	$2.09
Large Chain	$2.61	Other	$2.35

The auditors found that the differences between for-profit and non-profit homes lie mainly in three areas of asset costs:

1. **Taxes.** On the average, the for-profit asset cost for real estate and property taxes is $.24 per patient day higher.

2. **Costs for mortgages, leases, or rental agreements.** Taken together, the for-profit asset costs for these items are $.70 per patient day higher. Lease costs are similar for profit and non-profit homes, but mortgage costs differ markedly between the two. The difference is probably due to several factors:

   --A higher percentage of non-profit homes have no mortgage or lease costs at all. These homes will drive down the average for non-profit homes.

--Most of the recent changes in providers have been in the for-profit sector. Recent sales, which involve higher interest rates and higher prices for the homes themselves, will drive up the average for the for-profit homes.

--For-profit providers may be financing a greater portion of their property costs. If greater amounts of a purchase price are financed, interest payments will be higher.

3. **Depreciation.** Non-profit homes have higher depreciation costs, and this difference offsets somewhat the higher for-profit costs noted above. The average depreciation cost is $.13 per patient day higher in non-profit homes than in for-profit homes.

Changes of Providers Cause Reimbursement Rates to Rise, Especially for Property

As pointed out earlier, 58 intermediate care facilities had a change in provider between March 1982 and November 1983 and the rate of turnover is clearly accelerating. Most of these changes occurred in the for-profit homes, and in most cases property-related costs rose. These changes are, to a degree at least, passed along to the taxpayer. The new providers' property costs increased $57,749, or 47 percent, from an average of $121,984 to an average of $179,733. Of that increase, $51,614, or 89 percent, occurred in the asset cost.

The increase in asset costs was especially great for homes which were owner-operated both before and after the change. These 29 facilities' asset costs increased from an average of $56,375 to $126,354--an increase of 124 percent. For 13 facilities which changed from owner-operated to lease arrangements, asset costs rose 53 percent, and for the 12 which changed from one lessee to another, asset costs increased less than eight percent.

The State does not automatically reimburse adult care homes for all of these costs. As explained earlier in this report, the State's reimbursement system imposes limits on the amount that can be reimbursed. Nevertheless, the homes will be able to increase the amount of reimbursement they receive, both now and in the future. The changes in providers will affect reimbursement rates in the following three ways:

1. **Immediate increases in property reimbursement rates.** Before the change in provider, the average property cost for the 58 facilities was $5.04. After the change, the average was $7.44. Fifteen of the prior providers' costs exceeded the $6.00 property cost limit, compared to 49 of the new providers. Because of the change, the auditors estimated that the 58 homes could be reimbursed for as much as $650,000 in additional property costs during fiscal year 1984.

2. **Later increases in property reimbursement rates because of higher cost ceilings.** Controls in the program will keep these providers from receiving full reimbursement for property cost increases. At

least $1.2 million in property costs for these homes will not be reimbursed because the homes will be at the maximum reimbursement rate for property costs. However, these maximum rates are moving averages that are based on everyone's costs, and they are adjusted each year. The increased costs reported by the homes will drive up the average, and the homes will be able to receive a larger share of their costs in years to come. The auditors estimated that these 58 changes in providers would raise the maximum reimbursement rate for property for **all** providers from $6.00 a day to $7.41 a day. As more homes change providers, that rate will continue to rise.

3. **Increases in other reimbursement rates besides property.** A change in provider allows a home to adjust its rates immediately in all four cost centers. There is an incentive to do so, because otherwise a home must wait to justify an increase through its historical costs. The auditors analyzed the 18 homes for which they had both the old historical and the new prospective costs. Increases occurred in all four cost centers.

	Historical	Projected	1983 Limit
Administration	$ 3.19	$ 3.68	$ 3.35
Property	5.24	7.80	6.00
Room & Board	7.02	7.78	9.75
Health Care	10.04	11.84	13.47

Like property costs, the higher projected costs in administration exceed the limit and will not be fully reimbursed at first. But over time, these higher costs will act to raise the limits in those areas as well.

Assessing Controls Over Property Costs in the Medicaid Reimbursement System

The trends outlined above show that increasing financial pressure is being placed on the property cost center. As adult care homes change hands, property costs rise. Through the Medicaid reimbursement system, all or part of these costs are passed on to the State. The State's reimbursement system has controls that are designed to contain some of this financial pressure. The auditors examined these controls and assessed their effectiveness in containing costs.

The Reimbursement System Has a Number of Controls on Property Costs, and More Controls Have Recently Been Added

The reimbursement system contains a number of cost controls that apply to all four cost centers, including property. As explained earlier in this report, these controls include exclusion of programs and services not applicable to Medicaid patients, restrictions based on minimum occupancy rates, and percentile limits on reimbursement rates. In the property cost center, reimburse-

ment is limited to the 85th percentile. This restriction means that those homes with the highest costs will not be reimbursed for their full cost. If the 85th percentile limit for property costs is $6.00 per patient day, for example, a home reporting costs of $7.00 will receive reimbursement of only $6.00. In addition to the limitation on each cost center, total costs are also limited to reimbursement at no more than an adjusted 75th percentile.

The auditors determined how many facilities' reimbursement rates were limited by the 85th percentile maximum. That review showed that 52 of the 258 intermediate care facilities had property costs above the limit. Those 52 homes included 40 for-profit facilities (26 percent of all for-profits homes in the State) and 12 non-profit facilities (12 percent of all non-profit homes). Therefore, the 85th percentile limit clearly has an effect in limiting reimbursement.

In the area of property costs, the Department of Social and Rehabilitation Services has other controls that keep certain property costs from being passed along. These include the following:

1. **Only bona fide sales or leases will be allowed to increase rates.** Increased costs resulting from non-arms-length transactions will not be reimbursed. This regulation is intended to protect the state from reimbursing costs which are artificially inflated by the sale and resale of a home between related parties or from sale-leaseback arrangements.

2. **Only one property transaction each three years will be allowed to increase rates.** Due to this control, which was added in 1983, the buyer will be reimbursed at the existing rate if the seller has owned the property for less than three years. In leased homes, if the prior lessee had leased the property for less than three years, the new lessee will be reimbursed at the existing rate. These restrictions limit the effect of rapid turnover on reimbursement rates.

3. **Depreciation will be recaptured for early sales.** Sellers who have not owned the home for five years before selling it will pay back a portion of their depreciation. The amount they pay back is based on a sliding scale: 100 percent if they sell after one year, 80 percent the second, and so forth. This restriction provides an incentive for owners not to sell if they have held the property for less than five years.

In their review of facilities which recently changed hands, the auditors found cases in which each of these additional restrictions on property transactions had an effect on restraining costs. These included sales in less than three years, sales in less than five years, an apparent sale-leaseback, and a change of provider through stock acquisition rather than sale.

The Legislature Can Strengthen Existing Controls or Try Other Reimbursement Approaches if Better Containment of Property Costs Is Needed

Strengthening existing controls. The existing controls over property costs will slow the rate at which property reimbursement rises, but they will not stop

it. Property reimbursement rates are based on the "moving average" of actual costs. As homes are sold or leased for higher amounts, the higher costs are built into the average, and the reimbursement rate will rise accordingly.

One option for controlling such increases even further is to strengthen the kinds of controls already in use. Kentucky, for example, requires that an owner must hold a home for twelve years before a new owner can buy it and apply the full cost of the purchase to the reimbursement rate. If the home is purchased from an owner who has held it for only ten years, a percentage of the purchase price is not allowed in the new owner's reimbursement base. In similar fashion, Kansas could extend its provision for recapturing depreciation (now with a five-year limit) or its provision for disallowing purchase costs (now with a three-year limit). Kansas could also change its reimbursement rate from the current 85th percentile to some other percentile or to an amount determined in some other way. Additional measures could be taken to control lease costs as well.

It should be noted that some states, faced with spiraling costs and limited funds, have stopped adjusting property reimbursement on the basis of a sale at all. In these states, property values have in essence been frozen, and buyers must accept property reimbursement at the same rate as before the sale.

Providing incentives for existing providers to remain in business. Another possible drawback to the current system in Kansas is that it may actually encourage owners to sell homes rather than keeping them for longer periods. Adult care homes offer a number of short-term investment advantages--certain tax breaks, sources of capital, and the like. The current system may reinforce these short-term advantages more than it encourages long-term retention.

There are several ways to encourage providers to remain in business, each of which involves providing additional financial gain to counteract the attraction of capital gains which can be obtained from selling. These include providing a return on equity, providing a direct reimbursement of profits, and increasing the reimbursement rates to cover an increased portion of costs. These incentives would increase costs at first, and would become cost-saving measures only if they could slow the turnover of property sufficiently to hold down the level of rising property costs.

Adopting a "fee-for-capital" system. To offset the inequities that occur between reimbursement rates for similar facilities when one is sold and the other is not, some states have adopted "fee-for-capital" approaches to reimbursement. These approaches are also an attempt to resolve problems with selling and re-selling homes simply to drive up reimbursement rates (called "trafficking"), with lease-back arrangements, and with other short-term real estate manipulations.

These approaches eliminate or substantially reduce the role of sales or lease changes in reimbursement rates. Under one such approach, the state can establish a reimbursement rate for each home by setting a "fair rental value" that does not change as a result of changes in ownership or lessee. Fair rental values vary with such factors as the age and size of the facility, and the State controls the rate of increase to provide for inflation and profit. Other related approaches may take a sale or new lease into account, but they will impose

limits on the per-bed purchase or cost. Still other such approaches will limit reimbursable value of the home to the lowest of such measures as historical cost of the home, replacement cost, market value, or appraised value. The main attraction of such fee-for-capital systems is the apparent opportunity they provide to set prices for capital reimbursement which may not be as subject to market forces and which the industry may not be as able to affect or manipulate. By paying a fee, rather than "passing through" interest costs, providers are also encouraged to minimize their debt and attempt to find favorable financing. The current cost-based system does not provide such incentives.

Steps Can Also Be Taken to Improve the State's Monitoring of Property Practices in the Adult Care Home Industry

In their attempt to review such matters as changes in ownership, effects of sales and lease changes, and apparent profitability of adult care homes, the auditors were hampered by a number of limitations in the information currently collected by the State agencies. For example, it is very difficult to develop a chronological history of a home because providers change, the name of the home changes, and information about previous providers is rapidly removed from the computerized data base. There are also gaps in the data, both regarding ownership and costs. Some of these gaps occur because the two agencies most directly involved in the Medicaid program, the Department of Social and Rehabilitation Services and the Department of Health and Environment, collect only the information they need to document compliance with the particular regulations they enforce. Monitoring property practices more fully would require a broader view, and thus more information.

The State's ability to monitor what takes place in the property area could be substantially improved if certain changes were made. These changes might also allow the State to assess the effect of various kinds of changes in reimbursement rates and systems. Legislative Post Audit would suggest the following improvements:

1. Identifying each home with a permanent identifier number so that its history could be traced regardless of changes in name or provider.

2. Incorporating balance sheet information such as that used by auditors into the data base at the Department of Social and Rehabiliation Services so that reports on profitability could be generated each year.

3. Requiring adult care home owners or providers to supply documentation of each and every property transaction, regardless of its anticipated effect on licensure or reimbursement.

4. If fee-for-capital reimbursement systems are to be studied, development of better information about the age of facilities and their original construction costs by the Department of Health and Environment and the Department of Social and Rehabilitation Services will also be necessary.

APPENDIX A

The Kansas Reimbursement System

The basic reimbursement system used in Kansas is called a prospective rate-setting system. Under a prospective, or forward-looking, system, the reimbursement rates for Medicaid patients are based upon a home's historical costs in its previous reporting year. The provider's rate, once established, remains stable until the next year's historical costs are submitted and a new rate can be established. The rate-setting process involves several steps, as shown below:

1. **Providers report their costs for property, health care, room and board, and administration, and the State determines allowable costs for each one.** Costs are reported to the Department of Social and Rehabilitation Services, which examines them to determine their accuracy and disallows costs for programs and services which are not applicable to Medicaid patients. An example of such disallowed costs would be those associated with the operation of a beauty shop within the facility. To encourage providers to keep their facilities reaasonably full and to protect the State from reimbursing excessive per-patient day costs resulting from low occupancy, allowable patient-related costs are divided by the greater of the facility's total inpatient days (the number of bed days occupied by patients) or 85 percent of total certified bed days.

2. **Allowable costs are adjusted for inflation.** Next, historical inflation based on the Consumer Price Index is applied to some costs on a retrospective basis, and estimated inflation based on economic forecasts and budget limitations is applied to others on a prospective basis. This process takes into account market trends and also makes the cost reports for all homes, which are filed at various times during the year, more comparable. The adjusted cost center totals are then summed to determine total cost per patient day.

3. **Reimbursement limits are established.** This is done annually by sorting the facilities by level of care (intermediate care facility, intermediate care facility for the mentally retarded, and skilled nursing facility) and arraying the allowable per patient day costs for the facilities from high to low, for each of the four cost centers and for total costs. The limits are determined by selecting the amount which represents the selected percentile for each cost center and the total cost. The percentile limitations for each cost center are as follows:

Administration	75th percentile
Property	85th percentile
Room and Board	90th percentile
Health Care	90th percentile

The total cost is also subject to a limitation at the 75th percentile. Because the limit on each cost center is applied first, it is possible for a facility to have total costs which are below the 75th percentile but not receive full reimbursement if costs are above the limit in one cost center. It is also possible for a facility to have costs below the limit for each cost center, but not receive full reimbursement if the sum of its cost center totals exceeds the overall 75th percentile limit.

4. **After the limits are applied, an efficiency factor may be added to arrive at a final rate.** This is not a limitation, but rather a cost containment feature for the administrative cost center and the operating costs of the property center. Its purpose is to encourage providers to hold down costs in those areas in order to qualify for a higher efficiency payment. Costs in the room and board and health care cost centers are not included in the computation. The fixed costs in the property cost center are not included, either, so that both old and new facilities will have an opportunity to benefit from efficiency in operation.

   The efficiency factor is also intended to serve as an equalizer between efficient and inefficient operations. Without the factor, the inefficient providers would be rewarded with a higher rate due to their inefficiency while the efficient operators would be penalized with a lower rate. The maximum efficiency factor allowable is $.50 per patient day, for which a facility's costs in the administration cost center and the plant operating expenses must be at or below the 55th percentile. Facilities which are above the 95th percentile in those areas receive nothing.

A second type of reimbursement system, which is used in Kansas for new providers, is called a retrospective reimbursement system. Since new providers have no historical costs upon which to base their rates, they are required to file an initial cost report based on what they expect their first year costs to be. These projected costs are used to establish their rates for the first year of operation. The facilities are not required to maintain an 85 percent occupancy rate, but they are subject to the existing limits which were established on the basis of the historical costs of existing homes.

At the end of their first year of operation, new providers must submit a report of their actual historical costs over the projection period. Those costs are then audited, and the rate for the first year is adjusted retrospectively. If the difference between the projected costs and the retrospective rate has resulted in an overpayment to the facility, it must remit the overpayment to the State. If the difference has resulted in an underpayment to the facility, the State reimburses the difference. The historical costs for the new providers are then used in the manner first described, as the basis for a prospective rate for the facility's second year of operation, and they become a part of the historical cost base which is used to establish future limitations.

APPENDIX B

Factors Contributing to Financial Rewards from Adult Care Homes

Net Income. Net income is measured in accounting terms by subtracting total expenses from total revenue. Although it is the primary index of profitability of the home itself, it does not provide a clear view of financial gain to the owners, because expenses can include owner compensation.

Adult care homes can increase net income in several ways. First, they may be able to reduce actual expenses below the cost upon which their Medicaid reimbursement rate is based. (If they are successful in doing so, however, they will be able to retain these gains for only one year, because lower costs will result in a lower reimbursement rate in the following year.) Second, they may also be able to qualify for an efficiency factor of up to $.50 per patient day. However, the total amount which they will receive from this payment is not large. For example, a 48-bed intermediate care facility with 58 percent Medicaid occupancy and a $.50 efficiency payment per patient day would receive $5,081 in efficiency factor reimbursement in a year's time. The third and primary source of net income is from private-pay patients, for whom the charges and payments received can exceed the provider's cost.

The auditors reviewed the cost reports of 25 intermediate care facilities to determine their net income. The facilities included 11 which had recently been sold. They found wide variations in net income. Net income for the group which was sold averaged $1,009, and for the other homes, $17,164. For the homes which were sold, incomes ranged from a loss of $115,843 to an income of $38,109, and for the other homes, they ranged from a loss of $96,665 to an income of $292,502.

Cash Flow. Cash flow is obtained as the difference between cash received and cash paid out. The primary source of cash flow to the nursing home operator is from reimbursement of depreciation. This is because revenues from the reimbursement of depreciation are not absorbed by any equivalent cash expense. The costs paid for depreciation are intended to compensate providers for the "using up" of their property in the course of providing service to patients. There are a number of ways of determining how much depreciation is paid. In Kansas, reimbursement of depreciation is based on a straight line method (equal increments over the useful life of the property). The useful life of the real property is considered to be 40 years.

Cash flow from depreciation has many potential uses. One such use is to cover mortgage amortization (principal) payments and land costs, which are not reimbursed. Since amortization payments are generally quite low in the initial years of a mortgage, however, much of the provider's cash flow in early years is available to meet other expenses or be invested in other enterprises. Depreciation cash flow will not be sufficient to cover amortization payments in later

years of the loan, providing a powerful incentive to sell. If revenue is not sufficient to meet expenses, providers will need to raise additional cash by loaning the business money, investing additional funds, increasing long-term debt, selling stock, or transferring funds from a corporate headquarters. Unless the total of these actions remains adequately rewarding, owners will have an incentive to sell.

Because for-profit providers have the option of retaining cash flow in the business or distributing it, the auditors looked both at operations cash flow and "total" cash flow (what remained in the business after distributions and transfers). In both areas, they found wide variation, as shown in the following chart.

Homes That Were Not Sold	Average	Low	High
Operations Cash Flow	$ 13,943	$(121,167)	$303,216
Total Cash Flow	$(12,115)	$ (42,065)	$ 9,909
Homes That Were Sold			
Operations Cash Flow	$ 3,873	$ (72,825)	$ 51,914
Total Cash Flow	$ 6,528	$ (13,641)	$ 40,914

Amount of Owner Investment. Kansas does not reimburse providers for the use of their investment, or equity. Because interest payments will be reimbursed as long as they are reasonable by comparison to market rates, it is clearly an advantage to providers to finance as much of the cost of the facility as is possible. This concept is referred to as leverage, and it directly affects the owner's rate of return on his investment.

If a provider is able to obtain total leverage by financing everything with other people's money, the rate of return on any income which he is able to obtain is incalculable. Minimizing owner investment may also provide an incentive to construct or purchase a facility with a greater cost per bed.

The auditors could not clearly identify the amount of original owner investment in facilities that had not been recently sold, because when a substantial initial investment is required, the owner may be able to recover that money over time in various ways, or it may be necessary to invest additional money at a later date. For the facilities which were reviewed, current owner equity averaged $142,042 for the homes not sold, and $24,441 for the homes which were recently purchased.

It is apparent from several recent purchases which were reviewed that it is possible in Kansas to obtain highly leveraged financing both from private-sector lenders and through the use of industrial revenue bonds. Private lenders' willingness to provide highly leveraged financing relates to their assessment of risk and rate of return. The availability of industrial revenue bonds appears to relate to the community desire to provide an incentive for an adult care home to be built or to continue to operate. IRB financing is desirable to providers

because of the low interest rate, tax advantages, and the high leverage which it provides.

The auditors tested the effect of IRB financing on property costs by comparing the property costs of homes which are currently IRB-financed to those which are not. Facilities which had no remaining mortgage or lease expense were excluded from the comparison. Eighty-six facilities were identified which had been wholly or in-part financed by industrial revenue bonds. One-third each of the non-profit and for-profit facilities have current IRB financing. Most of those bonds were issued during the mid-1970's, although some are as old as 1965 and as recent as 1982. The total amount of bonds which were issued for the 86 facilities exceeded one hundred million.

The results of the comparison showed no significant difference between the property costs of the IRB-financed and non-IRB financed groups. Therefore, it would appear that any cost advantages which might be provided by the tax advantages and lower interest rate on IRB's may be negated by the financing 1) of a greater portion of the facility's cost, or 2) of higher costs per bed. Another possibility is that IRB-financed facilities may be newer than the non-IRB financed facilities and thus were constructed at higher cost.

Owner Withdrawals. As noted above, profits and cash flow of a for-profit business can be retained in the business or distributed. Adult care providers have several alternative ways to obtain money from the business. First, they or their spouses can be employed by the facility. If they choose to do so, their wages will be evaluated in comparison to those of others who perform the same jobs in other similar-sized facilities, and a limit will be established for the amount of costs which can be included in the Medicaid reimbursement rate. Although they can pay themselves more than this amount, the additional compensation must be funded from other sources. Second, they can loan themselves money. Although they must pay a reasonable interest for the loan, they do not necessarily have to pay back the principal until the facility is sold, at which time it would probably only matter as a bookkeeping adjustment. Third, corporations can pay dividends to their stockholders, and fourth, chain operators can transfer funds back to the central office.

Additional potential exists for moving funds from the facility in the administrative cost center through the allocation of central office expense and in employee benefits, especially in non-profit corporations. Those areas will be examined in greater detail in subsequent audits. In the homes which were examined, the amount of owner compensation which was paid ranged from nothing to $104,074 for homes not sold, and from nothing to $54,600 for homes which were sold. Total cash to owners ranged from nothing to $327,316 for homes not sold and $54,600 for homes which were sold.

Tax Advantages. A main consideration in determining the financial rewards available from an adult care home is the tax advantages which might accrue to the provider through its operation. Although the following is not intended to be a comprehensive list of such advantages, it provides some indication of the variety of possibilities which exist.

First, if an owner constructs a facility or arranges for the financing of construction, he can take as deductions for income tax purposes the interest on construction loans he would pay and real estate taxes paid prior to occupancy. These tax deductions could shelter other income from taxation. Second, during its operation, payment of income taxes would be considered as cash expense. However, it is after-tax cash flow which is most important to an investor. Owners are permitted to write off the depreciation of property on their income tax returns and may choose to use an accelerated basis or shorter time period than the one upon which they are being reimbursed. This additional depreciation can be used to shelter the payments which are received from Medicaid for depreciation fully from taxation and to shelter other income as well. In addition, mortgage and other interest expenses are fully deductible for tax purposes. Hence, revenues received from Medicaid reimbursement of property costs, expecially in early years, can be sheltered largely or completely from taxation, and apart from paying interest and mortgage amortization expenses, such revenues can be used to invest in other ventures, including other nursing homes.

Recent changes in federal tax laws have increased the tax advantages of property ownership in several ways. Tax credits are available for investment in capital equipment and for energy efficient improvements. In the capital equipment area, the credits are sufficiently attractive that new firms are emerging which purchase equipment and lease it back to businesses in order to obtain the tax credits. In addition, the time periods for depreciation of both equipment and real property have been shortened. In most cases, capital equipment can be depreciated over a 3 or 5 year period and most real property can be depreciated over a 15-year period. As a result, depreciation write-offs have become attractive investments, leading to the emergence of syndications comprised of general and limited partners. In such arrangements, the limited partners' primary motivation for investing in the property is to obtain a portion of the depreciation write-offs with which to shelter other income. Kansas now has at least one such limited partnership in the nursing home business.

Selling and Capital Gains. Since nursing home facilities are not directly suitable for other uses, the best sales option is generally to a purchaser who wants to maintain the facility as a nursing home. In the event of sale, the new provider is generally able to receive reimbursement based upon his purchase price for the facility, subject to the existing limits.

The Department of Social and Rehabilitation Services attempts to minimize the effects of sales in several ways. First, if the seller did not own the facility for at least 36 months, the buyer's rate of reimbursement will not be increased. Second, if the seller did not own the facility for at least five years, the seller will be charged for recapture of depreciation payments of 20 percent for each year of ownership less than five. Third, if the transactions were not at "arms-length" (between disinterested parties), the reimbursement will be based on the seller's costs of owning the property, not the amount which the buyer paid. However, in most cases a sale will result in a higher reimbursement rate for the same property, because of the increased cost basis of that property. The sale and resale of adult care homes just to increase the rate at which they are reimbursed is called "trafficking" in nursing home property.

The capital gain to the original owner (the difference between the value of the facility on his books and the sale price) is a form of net income. It is an advantageous form of income because it is taxed at capital gains rates rather than as ordinary income. The net cash flow resulting from a sale would be equal to the sales price less taxes paid and less repayment of any existing loans.

If an owner does not contemplate a rapid sale, there may be advantages to be gained in many cases from holding the facility for long periods, while land values increase, for purposes of selling at a higher price reflecting the value of the land itself. The costs of such speculation are reduced by Medicaid reimbursement of real estate taxes and other operating costs. Sale of land at a value higher than its original cost also generates income in the form of capital gains and would be preferentially taxed.

Leasing and Refinancing. Although selling clearly provides nursing home owners with a profitable option, leasing a facility to someone else may be a preferable choice in some cases. Kansas reimburses providers for their full lease costs as long as they appear to be reasonable. An owner faced with diminishing depreciation and increasing principal payments may have total mortgage payments which are below the current lease value of the facility. In such cases, the provider may be able to improve his position by leasing the facility to someone else to operate, although some of the income from that arrangement may be taxable.

Through lease arrangements, reimbursement can also be kept closer to market rates by adjusting the terms of the lease to allow for timely increases, or by tying the lease costs to the revenues received by the lessee. In addition, leases provide an opportunity for owners to remove themselves from the day-to-day operation of the facility without disposing of their asset. This may be particularly attractive if the owner can continue to receive income tax advantages from ownership of the property, or if he expects the increased sale price of the facility at a later date to provide a greater return than he would receive on his investment of current capital gains.

The stated advantages of leasing make it vulnerable to manipulation in the form of sale/lease-back arrangements which are non-arms-length transactions. Kansas does not reimburse providers for increased costs which result from these property transactions, when it is possible to determine that they have occurred. However, because of the complex nature of some nursing home property transactions and the speed with which transactions can take place, it is sometimes difficult to determine if lease costs should be reimbursed or not. The State's position in such cases has been to deny questionable rate increases. Lease cost increases due to sale or change in lessee in less than 36 months will also not be reimbursed.

Refinancing also may provide an owner with advantages in some cases. In Kansas, increased costs due to refinancing are not considered allowable costs unless the refinancing was necessary to build additional beds or to avoid receivership. If the owner should refinance, however, whatever net proceeds flow from the new arrangement are untaxed, and can be reinvested. This provides the owner an opportunity to withdraw his equity investment in the form of cash. Through refinancing, the owner also obtains a tax advantage by

avoiding the high mortgage amortization payments on the old mortgage, which are not tax deductible, and substituting higher interest payments required by the new mortgage, which are.

Medicaid-Reimbursable and Private Pay Patient Mix. Private-pay patients are a more favorable source of income than Medicaid patients. This is because the most Medicaid will pay for the care of a patient is cost plus an efficiency factor. In addition, if costs are above the reimbursement limits, providers will lose money on Medicaid patients. However, providers can charge private pay patients as much as they are willing and able to pay.

While most facilities accept at least a few Medicaid patients, the percentage varies by type of facility, as shown in the following table.

Medicaid-Reimbursed Days as a Percentage of Total Inpatient Days

	Non-Profit				
	Total	Mortgage	Lease	Comb.	Neither
Government	46%	40%	N/A	N/A	49%
Church	29%	25%	40%	N/A	32%
Other	44%	46%	44%	N/A	39%

Average for all non-profit: 40%

	For-Profit				
	Total	Mortgage	Lease	Comb.	Neither
Non-Chain	51%	52%	59%	41%	39%
Small Chain	52%	53%	49%	54%	46%
Large Chain	55%	62%	-	42%	45%

Average for all for-profit: 52%

For-profit facilities' willingness to accept Medicaid patients is generally assumed to relate to their ability to attract private-pay patients and to the ability to make money from Medicaid patients. Facilities with high per-patient day costs may be willing to accept high percentages of Medicaid patients because of the cash flow they provide, even if the facility's full costs are not reimbursed. In other cases, Medicaid patients are preferable to empty beds. However, as a facility's reimbursable property costs decrease, affecting its cash flow, it must attempt to decrease costs so that it is reimbursed for all of them, and also will attempt to achieve a higher efficiency factor and thereby some profit. By lowering overall costs, the home can also make more profit on private-pay patients, which makes it advantageous to increase their percentage of private-pay patients if possible.

Facilities which are successful in managing these factors can be very profitable. One facility the auditors reviewed had 17 percent Medicaid patients, and a net income of $292,502 during 1982. Between January 1976 and December, 1982, that facility paid $1,332,797 to its owners. By comparison, another facility with 68 percent Medicaid patients had a net income of $22,898

in the past year and had paid $84,651 in cash to its owner in the past six years. Although the facility is profitable, it is clear that profits could be greatly increased if it had fewer Medicaid patients.

Although the non-profits' percentages of Medicaid patients are lower, the "other" group within it may operate in a manner similar to that of the for-profit homes. The government-related facilities' percentage of Medicaid patients appears to rise as their costs decrease. The church-related facilities have the smallest percentage of Medicaid patients.

Relationship of Profit and Risk. This is not a factor that affects financial rewards, but it is one that affects decisions to enter the industry. Profits are the return to capital and the return to successful risk taking of a business venture. The greater the risk, the greater the profits which are necessary for capital formation, or in other words, to interest the private sector in becoming involved in the business. Although risk is difficult to evaluate, and points of view regarding the relative risk of the nursing home business compared to other businesses differ, several components can be identified. First, because of the increasing number of aged in need of adult care and the certificate of need procedures which are used to approve new adult care home construction, there is little risk that the occupancy rate of a adult care home will be at a level too low to cover costs. Second, since the Department generally reimburses full allowable costs, provided occupancy is not below 85 percent and the costs are within the limits, the risk that revenues will not be adequate to cover expenses, except in start-up months, is relatively low.

However, there are certain risks in the nursing home business which an owner must take into account. First, a nursing home is basically a single-purpose building. Thus, once having committed his capital to nursing home use an owner must either stay in the busines for some time or sell the facility as a nursing home. Second, the owner bears the risk that his home may not at some point be attractive to private-pay patients from whom substantial profits may be generated. Third, depending on the portion of Medicaid patients which the facility accepts, the owner runs the risk that law or regulations at the State or federal level affecting those patients will be changed, affecting his costs, or that the program will be terminated or substantially altered, possibly leaving him with patients who cannot pay for their care. Fourth, the owner faces the risk that a facility built to current code standards may not meet nursing home facility codes placed in effect at a future date, affecting both his costs and the ability to sell.

There is no reasonably objective way to evaluate such risks. However, if the degree of risk must be less than the possibility of profit in order to interest buyers in entering the market, the current rapid change in ownership of Kansas nursing homes would indicate that the risk is not unreasonably high.

APPENDIX C

Comparison of Operating, Personnel and "Other" Costs in the Property Cost Center

Although asset costs are primarily responsible for the property cost differences which were noted between types of homes, some variations do exist in the operating, personnel and "other" components of the property cost center. These differences are described below for the three primary classifications of homes.

1. **Profit or Non-Profit**

Comparison of the operating, personnel, and other costs of profit and non-profit groups showed that although the total property costs of non-profit providers are lower than those of the for-profit group, their costs in these three components are slightly higher than the for-profit group. The only difference which is meaningful is in personnel. The non-profit homes higher costs in this area could indicate they have more maintenance and custodial personnel, or that their personnel receive higher wages.

Profit or Non-Profit	Operating	Personnel	Other
Profit	$1.85	$.31	$.06
Non-Profit	$1.92	$.51	$.12

2. **In-State or Out-of-State**

In these three cost categories, out-of-State owners report slightly lower operating costs, but higher costs for personnel and other. These differences may relate to the fact that homes with out-of-state owners were slightly larger. Their average bed size was 73 beds, compared to 64 beds for the homes with in-state owners.

In State/Out of State	Operating	Personnel	Other
In-State	$1.91	$.38	$.05
Out-of-State	$1.70	$.47	$.25

3. **Ownership Type**

Comparisons of the operating, personnel and "other" cost components by ownership type showed that operating costs are higher for mortgage-lease combinations and for homes with neither mortgage nor lease expense. Higher costs for those with no mortgage or lease expense may indicate that their facilities are older, and more expensive to maintain. They may also relate to the fact that more of them are non-profit providers, who tend to have higher costs in these areas.

Ownership Type	Operating	Personnel	Other
Mortgage	$1.83	$.36	$.09
Lease	$1.82	$.35	$.04
Combination	$1.95	$.32	$.12
Neither	$2.03	$.50	$.08

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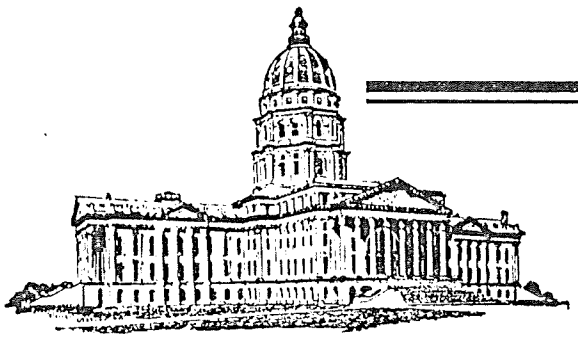


ADULT CARE HOME COSTS IN KANSAS— PROPERTY COSTS AND PRACTICES

A Presentation to the
House Public Health and Welfare Committee

January 16, 1984

Legislative Division of Post Audit
Trudy Racine, Senior Auditor
296-3792

Atch. 3

Comparisons of Average Daily Costs
For Homes With Rate Effective Dates
on or Before June 1, 1983

Skilled Nursing	Profit		Non-Profit	In-State		Out-of-State
Number of Homes	22		8	25		5
Total Cost	$29.80		$38.73	$31.83		$33.92
Administration	3.65		4.07	3.63		4.41
Property	6.08		7.65	6.12		8.39
Room and Board	7.17		9.09	7.85		6.87
Health Care	12.90		17.92	14.24		14.25

Intermediate Care	Profit		Non-Profit	In-State		Out-of-State
Number of Homes	152		108	218		42
Total Cost	$25.22	*	$27.86	$26.11	*	$27.36
Administration	2.81	*	3.15	2.85	*	3.47
Property	5.10	*	4.58	4.79		5.41
Room and Board	7.11	*	7.98	7.49		7.41
Health Care	10.19	*	12.15	10.99		11.07

NOTE: An asterisk between columns of numbers indicates that statistical tests show that the differences in average costs being compared are statistically significant. This means that there is little likelihood that the differences would have occurred as a result of chance.

Provider No. _____

EXPENSE STATEMENT (Continued)

Property Cost Center	Line No.	Per Books or Fed. Tax Return (1)	Provider Adjust-ments (2)	Patient Related Expenses (3)	SRS Adjust-ments (4)	Adjusted Pat. Rel. Expenses (5)
Real Est. & Personal Prop. Taxes	121					
Interest - Real Estate Mtg.	122					
Rent or Lease Expense	123					
Amort. Leasehold Improv.	124					
Depreciation Expense	125					
Salaries	126					
Employee Benefits	127					
Owner's Compensation - Sch. B	128					
Utilities except telephone	129					
Maintenance & Repairs	130					
Supplies	131					
Other (Specify)_____	137					
Other (Specify)_____	138					
Total - Property Cost Center	139					

This expense statement is part of the Financial and Statistical Report submitted to the Department of Social and Rehabilitation Services by each adult care home. This portion of the statement deals with property-related costs.

STATE OF KANSAS DEPARTMENT OF SOCIAL AND REHABILITATION SERVICES — SCHEDULE A PAGE 1
DIVISION OF MEDICAL PROGRAMS MEDICAID ADULT CARE HOME COST ANALYSIS — PROV NO.

PROVIDER INFORMATION

FACILITY NAME
ADDRESS
CITY/STATE/ZIP
ADMINISTRATOR
REPORT YEAR END 12/31/82
FISCAL YEAR END 12/31/82

BEDS AVAILABLE	CURRENT
SKILLED	0
INTERMEDIATE	50
MENTALLY RETARDED	0
OTHER	0
TOTAL	50
BED DAYS AVAILABLE	18250
INPATIENT DAYS	17613
OCCUPANCY RATE	96.5
CAL DAYS IF APPL	0
PAT DAYS USED IN DIV	17613

RECAP OF PATIENT RELATED EXPENSES AND RATE CALCULATION

	ADMIN	PROPERTY	ROOM & BOARD	HEALTH CARE	TOTAL
PAT RELATED EXP	47,085	45,241	116,542	182,279	391,147
COST PER PATIENT DAY	2.67	2.57	6.62	10.35	22.21
INFLATION	.07	.05	.24	.34	.70
PPD COST BEFORE LIMITS	2.74	2.62	6.86	10.69	22.91
PPD COST LIMITS ICF	3.35	6.00	9.75	13.47	28.16
ALLOWED COST	2.74	2.62	6.86	10.69	22.91

	ICF-MR	ICF	SNF
ALLOWED COST	.00	22.91	.00
MINIMUM WAGE ADJUSTMENT	.00	.00	.00
SUBTOTAL	.00	22.91	.00
EFFICIENCY FACTOR	.00	.50	.00
PER PATIENT DAY RATE EFFECTIVE 3/01/83	.00	23.41	.00
50 PRIVATE PAY RATE		26.30	

EXPENSE STATEMENT

DESCRIPTION	LINE NO.	REPORTED EXPENSE	PROVIDER ADJUSTMT	SRS ADJUSTMT	PATIENT EXPENSE	PER DAY
PROPERTY						
REAL EST & PER PROP TAX	121	3,468	0	0	3,468	.20
INTEREST-R E MORTGAGE	122	3,794	1,668-	0	2,126	.12
RENT OR LEASE EXPENSE	123	0	0	0	0	.00
AMORT LEASEHOLD IMPROV	124	0	0	0	0	.00
DEPRECIATION EXPENSE	125	21,050	6,436-	0	14,614	.83
SALARIES	126	2,230	0	0	2,230	.13
EMPLOYEE BENEFITS	127	207	0	0	207	.01
OWNERS COMPENSATION	128	0	0	0	0	.00
UTILITIES-EXCPT TELEPHONE	129	18,625	0	0	18,625	1.06
MAINTENANCE & REPAIRS	130	4,037	66-	0	3,971	.23
SUPPLIES	131	0	0	0	0	.00
OTHER	137	0	0	0	0	.00
OTHER	138	0	0	0	0	.00
TOTAL PROPERTY **	139	53,411	8,170-	0	45,241	2.57

This is part of a cost and reimbursement rate report for a for-profit home with 50 beds. This is an example of a home with costs that are well below the reimbursement limit in property and the three other cost centers.

STATE OF KANSAS DEPARTMENT OF SOCIAL AND REHABILITATION SERVICES — SCHEDULE A PAGE 1
DIVISION OF MEDICAL PROGRAMS MEDICAID ADULT CARE HOME COST ANALYSIS — PROV NO.

PROVIDER INFORMATION

FACILITY NAME
ADDRESS
CITY/STATE/ZIP
ADMINISTRATOR
REPORT YEAR END 9/30/82
FISCAL YEAR END 9/30/82

BEDS AVAILABLE	CURRENT
SKILLED	0
INTERMEDIATE	65
MENTALLY RETARDED	0
OTHER	0
TOTAL	65
BED DAYS AVAILABLE	23725
INPATIENT DAYS	21558
OCCUPANCY RATE	90.9
CAL DAYS IF APPL	0
PAT DAYS USED IN DIV	21558

RECAP OF PATIENT RELATED EXPENSES AND RATE CALCULATION

	ADMIN	PROPERTY	ROOM & BOARD	HEALTH CARE	TOTAL
PAT RELATED EXP	93,253	130,567	167,935	210,763	602,518
COST PER PATIENT DAY	4.33	6.06	7.79	9.78	27.96
INFLATION	.17	.10	.39	.40	1.06
PPD COST BEFORE LIMITS	4.50	6.16	8.18	10.18	29.02
PPD COST LIMITS ICF	3.35	6.00	9.75	13.47	28.16
ALLOWED COST	3.35	6.00	8.18	10.18	27.71

	ICF-MR	ICF	SNF
ALLOWED COST	.00	27.71	.00
MINIMUM WAGE ADJUSTMENT	.00	.00	.00
SUBTOTAL	.00	27.71	.00
EFFICIENCY FACTOR	.00	.10	.00
PER PATIENT DAY RATE EFFECTIVE 10/01/82	.00	27.81	.00
50 PRIVATE PAY RATE		31.50	

EXPENSE STATEMENT

DESCRIPTION	LINE NO.	REPORTED EXPENSE	PROVIDER ADJUSTMT	SRS ADJUSTMT	PATIENT EXPENSE	PER DAY
PROPERTY						
REAL EST & PER PROP TAX	121	5,313	0	0	5,313	.25
INTEREST-R E MORTGAGE	122	61,074	0	0	61,074	2.83
RENT OR LEASE EXPENSE	123	2,525	0	0	2,525	.12
AMORT LEASEHOLD IMPROV	124	0	0	0	0	.00
DEPRECIATION EXPENSE	125	29,109	0	0	29,109	1.35
SALARIES	126	4,679	0	0	4,679	.22
EMPLOYEE BENEFITS	127	654	0	0	654	.03
OWNERS COMPENSATION	128	0	0	0	0	.00
UTILITIES-EXCPT TELEPHONE	129	22,754	167-	0	22,587	1.05
MAINTENANCE & REPAIRS	130	3,681	60-	0	3,621	.17
SUPPLIES	131	0	0	0	0	.00
OTHER	137	621	0	0	621	.03
OTHER	138	384	0	0	384	.02
TOTAL PROPERTY **	139	130,794	227-	0	130,567	6.06

This is part of a cost reimbursement rate report for a for-profit home with 65 beds. This is an example of a home with costs that exceed the reimbursement limit in property and administration cost centers.

Classification of Intermediate Care Facilities

	Total	Mortgage	Lease	Combination	Neither
For-Profit Homes:	**156**	**92**	**30**	**14**	**20**
Non-chain	77	46	15	5	11
2-5 Small chain	45	25	15	3	2
6-more Large chain	34	21	0	6	7
Non-Profit Homes:	**102**	**57**	**7**	**0**	**38**
Government	25	8	0	0	17
Church	27	15	2	0	10
Other	50	34	5	0	11

Corporations
Good Samaritan

Property Costs

The average property cost for the 258 intermediate care facilities was $4.87 per patient day. This average cost was broken down as follows:

Asset Costs: includes taxes, interest on mortgage, rent or lease expense, amortization of improvements, and depreciation.	$2.52
Operating Costs: includes utilities (except telephone), maintenance and repairs, and supplies for maintenance and repairs.	1.88
Property-related Personnel Costs: includes salaries and benefits for maintenance personnel, and owner compensation for maintenance related work.	.39
Other Costs: miscellaneous property-related items	.08
Total	$4.87

Differences in Asset Costs

Average asset costs for all homes:	$2.52
Average asset cost for-profit homes:	$2.82
Average asset cost for non-profit homes:	$2.07

The differences between for-profit and non-profit homes lie mainly in three areas of asset costs:

1. **Taxes.** On the average, the for-profit asset cost for real estate and property taxes is $.24 per patient day higher.

2. **Costs for mortgages, leases, or rental agreements.** Taken together, the for-profit asset costs for these items are $.70 per patient day higher.

3. **Depreciation.** The average depreciation cost is $.13 per patient day higher in non-profit homes than in for-profit homes, and this difference offsets somewhat the higher for-profit costs noted above.

Changes In Ownership and Lease Patterns

For 58 intermediate care facilities that reported a change in provider between March 1982 and November 1983:

1. **There is a clear trend from in-State to out-of-State ownership.**

Before the change, here is how the providers were classified...		After the change, here is how the providers were classified...	
In-State, for-profit:	44	In-State, for-profit:	19
In-State, non-profit	3	In-State, non-profit:	1
Out-of-State, for-profit:	8	Out-of-State, for-profit:	36
Out-of-State, non-profit:	3	Out-of-State, non-profit	2

2. **Chain ownership is growing.**

Before the change, here is how the for-profit providers were classified...		After the change, here is how the for-profit providers were classified...	
Non-chain:	24	Non-chain:	7
Small chain:	14	Small chain:	27
Large chain:	14	Large chain:	21

3. **Lease arrangements are increasing.**

Before the change, here is how for-profit and non-profit providers were classified...		After the change, here is how for-profit and non-profit providers were classified...	
Mortgage:	34	Mortgage:	33
Lease:	13	Lease:	25
Combination:	9	Combination:	0
Neither:	2	Neither:	0

When Homes Change Providers, Reimbursement Rates Increase

1. **Some Homes Can Raise Their Rates Immediately**

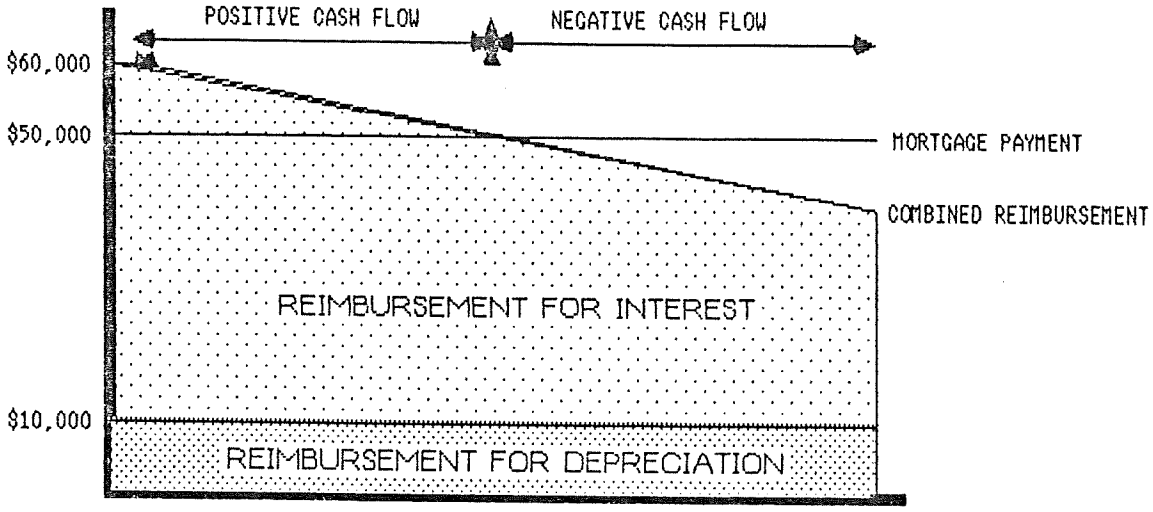
Property Costs:

	Before Sale:	Projected After Sale:
Real Estate & Personal Prop. Taxes	$ 25,949	$ 25,949
Interest -- Real Estate Mtg.	29,470	128,237
Rent or Lease Expense	3,973	-0-
Amort. Leasehold Improv.	-0-	-0-
Depreciation Expense	35,704	62,657
Salaries	10,846	-0-
Employee Benefits	1,240	11,388
Owner's Compensation	-0-	-0-
Utilities except telephone	41,125	53,462
Maintenance & Repairs	26,532	30,777
Supplies	12,579	14,340
Other	2,057	2,344
Other	3,335	-0-
TOTAL	$192,810	$329,154
	$5.36 Per Patient Day	$9.25 Per Patient Day

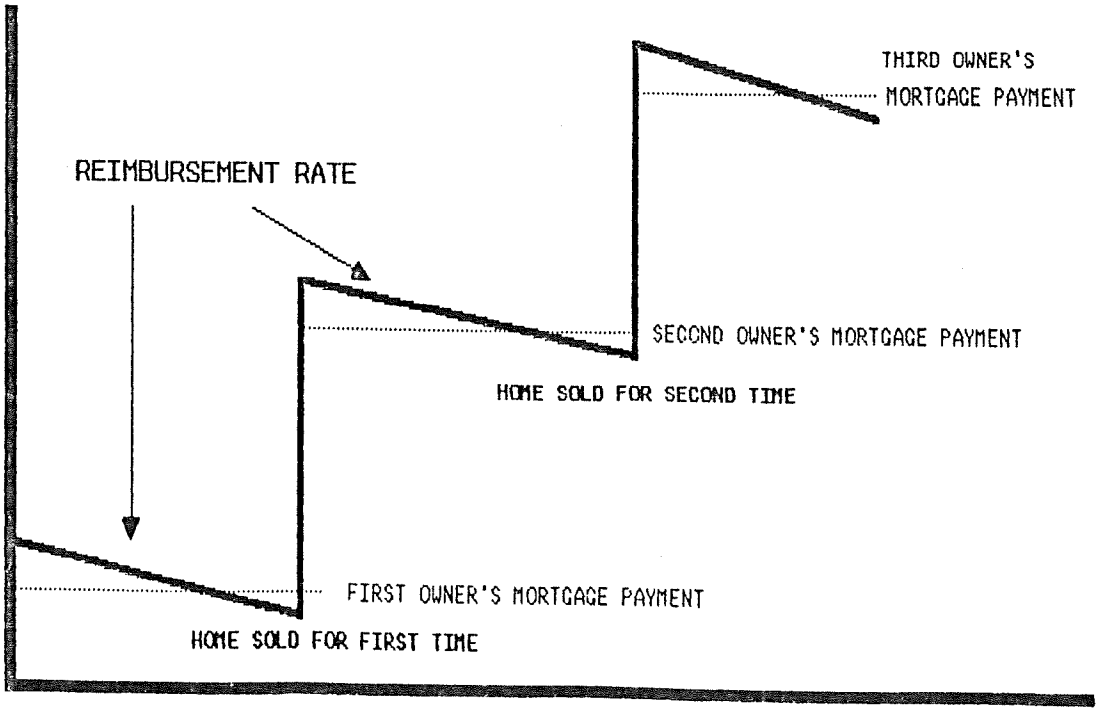
2. **Higher Property Costs Will Cause the Maximum Reimbursement Rate to Rise in Future Years.**

3. **Other Rates Besides Property Are Also Affected**

Decreases in Asset Reimbursement Can Make Selling an Adult Care Home Desirable



These Sales Cause Abrupt Increases in the Asset Reimbursement Rate



ADULT CARE HOME FINANCES—SOME EXAMPLES

Example 1: This home was financed with $700,000 in industrial revenue bonds in 1975. In 1977, when the auditors picked up the financial history, the two owners had an equity of about $40,000. Between January 1977 and June 1982, the two owners reported a net loss for the facility of nearly $70,000. In that five-year period, the two worked full-time and received compensation and dividends totaling about $283,000. When they sold the home in June 1982, they received an apparent capital gain of nearly $320,000.

Example 2. This home was purchased in August 1978 for $800,000, with an apparent initial investment by the owners of $5,000. Between 1978 and April 1982, the owners reported a net income for the facility of $60,000. One owner worked full time, the other three-fourths time, and they received a total of nearly $180,000 in compensation and loans during the period. They sold the home for $1.2 million, realizing nearly $500,000 in capital gains.

Example 3. This facility had a net loss of nearly $100,000 in 1982. In addition, an increase in outstanding debts and current liabilities resulted in a negative operations cash flow of $121,000. The owner invested an additional $116,500 which decreased the cash flow deficit to less than $5,000 and finished the year with a negative equity of about $142,000. This facility had an unusually low occupancy rate of 67 percent and a high percentage of Medicaid patients (69 percent), combined with costs which were above the maximum reimbursement rate in two cost centers and overall.