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THE NEWSLETTER FROM THE BDO HEALTHCARE PRACTICE

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CONTENTS

THE "STATE" OF MEDICAID REIMBURSEMENT – AN UPDATE

By Randy Severson, Assurance Director with BDO

The American Health Care Association (AHCA) recently released its annual report (2010) on the "state" of Medicaid reimbursement. AHCA engaged Eljay, LLC (1) to conduct what is the ninth such study which is entitled "A Report on Shortfalls in Medicaid Funding for Nursing Home Care." Data was obtained from 39 states from 2008 cost reports (or 2009 if available). This data was used to determine the shortfall in Medicaid funding in 2008 as well as to project the shortfall in 2010. Those unfamiliar with Medicaid funding of nursing homes might very well be shocked by what the report reveals. Unfortunately, those of us who have been involved in the industry for many years are not.

The average shortfall in Medicaid reimbursement for nursing homes was $16.79 per Medicaid resident day in 2008 while the Medicaid shortfall in 2010 was projected to be $17.33. Based on past study results, the actual shortfall in 2010 will likely be higher than initially projected due to greater than projected inflationary pressures on nursing home costs. The projected 2010 shortfall represents unreimbursed allowable costs of over $5.6 billion.

Unlike Medicare, Medicaid programs are state-specific. As a result, there are wide variations in the shortfall when comparing different states. Although the state of Wisconsin ranked dead last in terms of the projected Medicaid shortfall in 2009, there were a total of five other states that were projected to rank worse than Wisconsin in 2010. Wisconsin's projected shortfall in 2010 is $26.54 per Medicaid resident day. States projected to rank worse

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THE "STATE" OF MEDICAID REIMBURSEMENT

Medicaid rate setting will undergo significant changes in upcoming years as greater emphasis will be placed on achieving efficiency, economy and quality.

than Wisconsin include New York ($47.95), New Hampshire ($31.25), Massachusetts ($31.22), New Jersey ($29.29) and Washington ($28.18). In contrast, the states of North Dakota ($2.36) and Idaho ($7.97) are projected to provide small profit margins.

The future outlook for Medicaid payment, at least in the near term, does not alter this somber "state." As a result of unprecedented state budget deficits and the expiration of the recent federal stimulus funds, the outlook is worse than ever before. As a result, nursing home providers will likely face rate freezes, if not significant rate reductions. This is further exacerbated by the states continuing to redirect more of their Medicaid budgets to home and community-based services. The report notes that over the last ten years, Medicaid expenditures on nursing home care have been reduced by 24.5% while spending on home and community-based services has increased by 72%.

Provider taxes are a major funding source for rate increases in many states. Overall, provider taxes generate over $5.5 billion in federal matching funds and in those states where implemented, reimburse an average of $19 per resident day in allowable Medicaid costs. However, provider taxes cannot be counted on to provide nursing home rate increases as they have in the past. Most states with high Medicaid volumes have already implemented such programs and many programs are at or near the upper limit of revenues that can be raised through such programs. It appears that most states with provider tax programs have used newly generated funds or enhanced funding as a result of the American Recovery and Reinvestment Act of 2009 to reduce state budget deficits as opposed to increasing rates.

Medicare continues to subsidize the shortfall in Medicaid funding. According to the Medicare Payment Advisory Commission, the average margin on Medicare payments to nursing homes in 2008 was 16.5%. For those providers with their "fair share" of Medicare residents, the margin on Medicare residents significantly reduces the Medicaid shortfall. Clearly, the future viability of nursing home providers hinges not only on future Medicaid shortfalls but the preservation of Medicare margins as well.

Since 2004, Medicaid rate increases have generally kept pace with nursing home cost increases. However, it appears that this trend has ended. As part of the report's data gathering, FY 2011 provider rates were requested. From this data, it was calculated that the change in rates between FY 2010 and FY 2011 was one half of one percent (.5%). More than half of the 38 states reporting indicated either no rate increase or a rate decrease for FY 2011.

Medicaid rate setting will undergo significant changes in upcoming years as greater emphasis will be placed on achieving efficiency, economy and quality. The report suggests that providers may have to meet all three expectations to be successful with Medicaid funds reallocated to those providers that can accomplish all three objectives.

(1) The President of Eljay, LLC is Joseph Lubarsky, a retired BDO partner. For a copy of "A Report on Shortfalls in Medicaid Funding for Nursing Home Care," contact the American Health Care Association.

For more information, contact Randy Severson, Assurance Director, Healthcare Practice, at rseverson@bdo.com.

WHAT TAX-EXEMPT HOSPITALS MUST DO IN ORDER TO KEEP TAX-EXEMPT STATUS

By Laura Kalick, JD, LLM in Tax

THERE ARE FOUR POLICIES THAT A TAX-EXEMPT HOSPITAL MUST PUT IN PLACE IN ORDER TO MAINTAIN ITS INTERNAL REVENUE CODE (IRC) SECTION 501(C)(3) EXEMPTION.

The Patient Protection and Affordable Care Act (the Act) added IRC 501(r) with its four requirements, three of which must be met now in order for a hospital to maintain its tax-exempt status.

In order to qualify as a 501(c)(3) hospital, a facility must meet the following requirements of the newly created IRC Section 501(r):

1. Financial Assistance Policy

A hospital must have a widely publicized written financial assistance policy which includes eligibility criteria for financial assistance and whether such assistance includes free or discounted care; the basis for calculating amounts charged to patients and the method for applying for financial assistance. The policy must also provide that the organization will provide emergency medical care regardless of an individual's eligibility under the financial assistance policy.

Timeframe: do now before end of fiscal year.

2. Charges Policy

A hospital must have a policy that limits amounts charged for emergency or other medically necessary care provided to individuals eligible for assistance under the financial assistance policy to not more than the lowest amounts charged to individuals who have insurance covering such care, and prohibits the use of gross charges.

Timeframe: do now before end of fiscal year.

3. Billing and Collection Policy

A hospital will meet this requirement only if the hospital does not engage in extraordinary collection actions before the organization has made reasonable efforts to determine whether the individual is eligible for assistance under the financial assistance policy described above.

Timeframe: do now before end of fiscal year.

4. Community Health Needs Assessment

The fourth requirement, the Community Health Needs Assessment (CHNA), which must be conducted every three years, is effective beginning two years after the date of the enactment of the Act, i.e., March 23, 2012.

Hospitals are required to conduct a CHNA at least every three years and adopt a strategy to meet the community needs identified through the assessment. If an organization fails to meet the CHNA requirement, then new section 4959 imposes a $50,000 excise tax for any taxable year for which there is such failure. Hospitals will have to provide the CHNA report *and their audited financial statements as attachments to Form 990.*

Effective beginning two years after date of enactment of Act, i.e., March 23, 2012.

▶NEW SCHEDULE H

The IRS has published a new Form 990 Schedule H that reflects the changes in the law in Part V, Section B, Facility Policies and Practices. Due to late revisions to the Schedule H and IRS systems, an automatic extension has been granted to many 2010 Form 990 hospital filers. If the initial due date of a hospital's return would have been August 15, 2011 or earlier (i.e., the hospital's year-end is December 2010 or January, February or March 2011), the hospital has an automatic three-month extension of time to file the Form 990 for 2010.

Additionally, the IRS does not want these hospital organizations to file the 2010 Form 990 before July 1, 2011. However, if a hospital has a June 30 year-end, the 2010 Form 990 would be due November 15, 2011 and with all extensions, could be filed as late as May 15, 2012. Note that the automatic extension only applies to hospitals that would have had an initial filing due date of August 15th or earlier. All hospitals should note that the questions on the form relate to whether the policies were in place during the tax year in question, which means that in order to answer the questions "yes," a hospital with a June 30 year-end will have to have the policies in place by June 30, 2011. The new Schedule H can be found at: http://www.irs.gov/pub/irs-pdf/f990sh.pdf

For more information, contact Laura Kalick, National Director, Nonprofit Tax Consulting, at lkalick@bdo.com.

2010 FORM 990: CALM AFTER THE STORM, WITH SOME CHALLENGES TO COME

By Joyce Underwood, CPA

WE ARE NOW APPROACHING THE THIRD YEAR OF THE REDESIGNED FORM 990 WITH ITS 14 NEW LETTERED SCHEDULES.

Organizations that were required to file a return and have not filed for three years are currently receiving notices from the IRS of their exemptions being revoked. The population of organizations recognized as exempt by the IRS will likely grow smaller as noncompliant or old and defunct organizations are removed from the the IRS Master Files. Data from the initial two years on the new IRS form is slowly becoming public as returns are released for public inspection. While the IRS may be constrained by budget concerns, more information available in databases on exempt organizations should increase focus both by the IRS and other third parties interested in exempt organizations. During 2010 the IRS has spent time fine-tuning the forms to make them clearer and to provide more elaborate instructions and examples for frequently misunderstood items.

With the end of the phase-in of the new form, thresholds initially raised in 2008 are lowering back down to require more organizations to file a regular Form 990. For tax years 2010 and later, organizations with either gross receipts of $200,000 or more or total assets of $500,000 or more are required to file Form 990. Smaller organizations can still use the Form 990-EZ. Important to note for 990-EZ filers: the IRS no longer allows white paper attachments, but requires the use of the Form 990 Schedule O for all supporting information filed with the return. One positive item to note is that the 990-N, e-Postcard threshold increased, allowing qualified organizations to use 990-N when receipts are normally less than $50,000, instead of $25,000.

The 2010 Form 990 includes certain cosmetic changes and a rearrangement of content for better readability and function. Headings of 990, Parts III, V, VI, VII, XI, and XII include new checkboxes when a response is included on Schedule O to cross reference this information back to the form. New narrative parts have been added to Schedules E, G, K, L and R to supplement responses to questions within the schedule instead of using Schedule O. Schedule O should now be used only to supplement core form responses or to include other general information not specific to one of the 14 schedules. Additionally, continuation sheets on Schedules F-1, I-1, J-1, J-2, N-1, and R-1 are eliminated, which is a welcome change. Continuations of lists are no longer found in distant locations where they have been causing some confusion. Instead, additional space for listing items now uses duplicate copies of the relevant schedules placed right after the initial pages so information is continuously presented. Subtotals are also added for each page.

Certain clarifications are provided for Part IV, Checklist of Required Schedules. All section 501(c)(3) filers with a section 501(h) election in effect for the tax year must file Schedule C, II-A. Section 501(c)(4), (c)(5), and (c)(6) organizations with membership dues, assessments, or similar amounts must complete Schedule C, III. Organizations with one or more hospitals must attach their audited financial statements. Transactions with a section 512(b)(13) controlled entity must complete Schedule R, Part V, line 2. There is an exception for certain transactions under $50,000.

For Part V, Statements Regarding Other IRS Filings/Tax Compliance, IRS instructions explain how to calculate member income for purposes of the 85% Member Income Test, and include a new tip explaining when section 501(c)(12) organizations must file Form

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2010 FORM 990

1120. New lines are also added to require organizations that received any payments for indoor tanning services during the tax year to indicate whether they have filed a Form 720 to report such payments.

Some of the unclear areas under Part VI, Governance, Management, and Disclosure, have received further explanation. The IRS now reminds us that the governing board is considered to have adopted a policy only if such policy was adopted by the end of the tax year. Only business and family relationships between the organization's current (not former) directors, trustees, or key employees are required to be identified. The instructions give two new examples to clarify the meaning of "local chapters, branches, and affiliates." The IRS clarifies what many believed; that providing the board a copy of the 990 must be answered "No" if you have redacted or removed any information (such as names and addresses of contributors or compensation) or limit the copy to less than the full voting board.

A few clarifications for Part VII, Compensation, have been added. The checkbox in Section A, line 1a, should be checked if neither the organization nor any related organizations compensated any current officer, director, or trustee of the organization. If a related organization is related to the filing organization for only a portion of the tax year, you may choose to report compensation paid by the related organization only during the time it was related. Reportable compensation for officers and employees is clarified to include both Form W-2, box 5, and Form 1099-MISC, box 7, if applicable. You must also describe on Schedule O the average weekly hours each listed person worked for any related organization. The compensation table now clarifies reporting for Part VII and Schedule J of certain amounts deferred under qualified and nonqualified plans.

Part VIII, Revenue, instructions clarify that neither donations of services (including the value of donated advertising space or broadcast air time) nor donation of use of materials, equipment, or facilities may be reported on Form 990, even though they are included on GAAP (generally accepted accounting principles) financial statements. They also clarify the reporting of donated items sold at an auction by providing an example in the instructions.

For Part IX, Expenses, the IRS clarifies that the costs incurred to secure funding should be allocated to "program" expenditures where program services are provided to the grantor or other contracting party, but allocated to "fundraising" expenditures when services are provided to the general public which is more in line with financial reporting. The revised instructions clarify the allocation of the salaries and benefits expenses to lines 5-10 for reimbursed payroll costs when reimbursing payroll agents, common paymasters, and other third parties for compensation paid to the organization's officers, directors, trustees and employees, while payments to a third party go on 11g, other services. Also, due to the size limitation for itemizing other expenses on the "other" line, miscellaneous expenses listed on these lines that are greater than 10% of the total expenses must be further itemized on Schedule O.

There are few changes to note on Part XI, Reconciliation of Net Assets, but reconciliation from beginning to ending net assets has been added. The former Part XI, Financial Statements and Reporting questions are now included under Part XII.

The IRS continues to have an international focus among all types of return filers. Schedule F, used to report foreign transactions, includes a Part IV which requires identification of transfers or ownership in foreign entities and operations in or related to boycotting countries, and reminds organizations of the need to file international form types 926, 3520, 5471, 8621, 8865, and 5713, if appropriate. (Foreign bank account reporting is still an emphasis with questions both in the core part of Form 990 and on the 990-T regarding foreign account holders and signers.)

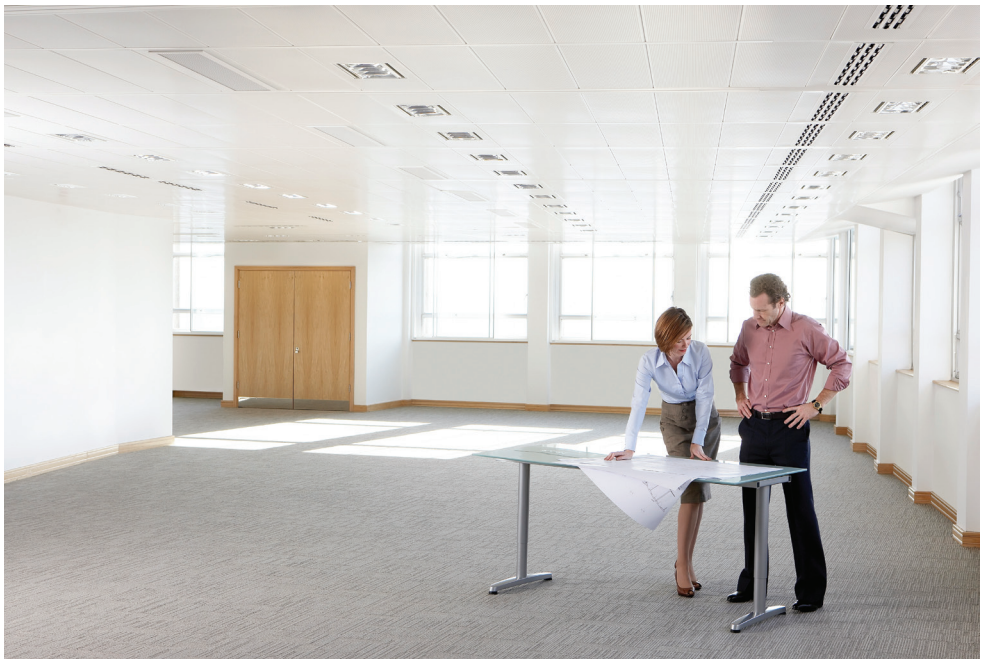
Both the 2009 and 2010 Form 990 require expanded reporting under Schedule K for tax-exempt bonds to include all of the new questions. The sections include Bond Issues; Use of Proceeds; Private Business Use; and Arbitrage. Some of the information can be gathered from the organization's bond information return, Form 8038, that is filed after a bond is issued. Other information relates to activities since the bond was funded.

Expanded reporting is also required for 2010 for tax-exempt hospitals on Schedule H. The Patient Protection and Affordable Care Act, effective for tax years starting after March 23, 2010, included additional requirements for tax-exempt hospitals to maintain their tax-exempt status. Due to late revisions to both the forms and systems to reflect new requirements for 501(c)(3) hospitals, the start of the filing season is delayed for certain hospitals. Tax-exempt hospital organizations may not file their 2010 Forms 990 (with Schedule H attached) before July 1, 2011. Hospital organizations with original 2010 tax year filing due dates before August 15, 2011 will be granted a three-month automatic extension. (See related article on page 1 of the newsletter for more detailed information on this issue.)

The beginning of the third year of the new Form 990 is a good time to look back at the accomplishments of the expanded requirements and to positively note how many organizations have worked to file timely and compliant returns. Many are better understanding some of the issues that surround the industry, while more transparency for some has been and will continue to be difficult to adjust to. The IRS is expected to use some of the information to better understand the various types of organizations that make up the diverse population, to target their resources toward it, to focus exams and inquiries on the right issues and organizations, and to provide better data about exempt organizations to Congress. They will continue to rely on the public to keep watch, and also provide educational information to better assist the industry, especially the new and growing organizations. New applications for exemption continue at a steady pace, and the industry continues to grow and change with the ebb and flow of the economy. Future changes to the 990 will occur, no doubt, as the environment changes and new issues take predominance.

For more information, contact Joyce Underwood, Director, Nonprofit Tax Services, at junderwood@bdo.com.

ACCOUNTING FOR LEASES – INCLUDING A PROPOSED NEW ACCOUNTING STANDARD



By Dick Larkin, CPA

AS OF EARLY 2011, ACCOUNTING FOR LEASES IS THE SUBJECT OF FASB STATEMENT NO. 13 AND ITS NUMEROUS AMENDMENTS (CODIFIED IN TOPIC 840 OF THE FASB ACCOUNTING STANDARDS CODIFICATION).

Its requirements are not discussed in detail in this article as they are in no way peculiar to nonprofit organizations, and are discussed elsewhere.

Briefly, leases are currently classified as either "operating" leases or "capital" leases; the criteria for classification being, in essence, whether or not the lease amounts in substance to a purchase of the asset by the lessee. There are four specific criteria used in making this distinction. Leases meeting one or more of the criteria are capital leases; all others are operating leases.

Operating leases are not reported on the lessee's balance sheet (statement of financial position); rather, each year's rent is reported as an expense of that year, and the future obligation to make rental payments is disclosed in a footnote.

Capital leases are reported essentially as purchases by the lessee (similar, but reverse, criteria apply to the financial statements of lessors); the asset is capitalized on the lessee's balance sheet, with a corresponding liability for the future lease payments. The asset is amortized over the lease term, and the liability is reduced by the periodic rental payments.

FASB (jointly with the International Accounting Standards Board) is currently working on a project to revise this standard, and had earlier decided that after some future date – probably within a couple of years, all leases would be accounted for in essentially the way capital leases are now. For operating leases, this change will normally have little effect on an organization's income statement, since what is now reported as rent expense will henceforth be reported as amortization expense of a similar amount. The principal effect will be to gross up the balance sheet for the asset and liability described above, with little or no effect on net assets. An Exposure Draft (ED) to this effect was issued in 2010.

In many cases, this gross up will not matter to financial statement users; however, organizations should consider whether the increase in liabilities will negatively affect compliance with covenants contained in any debt and grant agreements to which the organization is subject. For example, if there is a covenant requiring the maintenance of no more than a certain maximum ratio of debt to equity (net assets), the debt amount will be higher, while the equity amount will probably not change, possibly causing the organization to be in violation of the covenant.

For example, suppose that under the current accounting rules, an organization's balance sheet reports assets of $1 million, liabilities of $600,000, and net assets of $400,000. Its debt-to-net assets ratio is 1.5 to 1. Further suppose it is subject to a covenant requiring this ratio to be no greater than 1.8 to 1. Further suppose again it has leases now classified as operating leases, which, when their future obligations are calculated under FASB's proposed new rules, will add another $200,000 of liabilities. Total liabilities will now be $800,000 (total assets will now be $1.2 million, so net assets will remain at $400,000) and the ratio will be 2.0 to 1 – in violation of the covenant.

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ACCOUNTING FOR LEASES

Consequences of this violation might – depending on the terms of the debt or grant agreement – include:

- acceleration of the debt repayment schedule, including possibly making the entire amount immediately due
- inability to refinance or roll over the debt, or cancellation of a line of credit
- increase in the interest rate on the debt
- increased reporting requirements
- a requirement to post additional collateral
- cancellation of future grant payments on current grants
- inability to obtain future grants from that funder

Organizations should identify any such covenants to which they are subject, determine whether they are likely to find themselves in violation after the revised accounting standard takes effect, and, if so, discuss the matter with the other party to the covenant (lender or funder) to try to have the covenant modified.

▶UPDATE ON TYPES OF LEASES

At a joint meeting in February 2011, the FASB and IASB Boards (the Boards) tentatively concluded that there are two different types of leases, rather than a single type. The change in direction results from outreach activities and comment letter responses to the original proposal. Some Board members described the first type (the "finance" lease) as a contract in which the lessee essentially purchases the underlying asset by obtaining substantially all of its risks and rewards through the lease. The second type of contract (the "other-than-finance" lease) is intended to create more financial flexibility, to mitigate the risk of ownership (for example, technological obsolescence), and/or to outsource the maintenance of an asset.

The current working definitions for each type of lease are:

Finance lease – The profit or loss of a finance lease has a pattern consistent with the 2010 ED, including interest expense/income using the effective interest method, as well as the lessee's amortization of its right-of-use asset. This profit or loss pattern reflects leases that contain a significant financing element where the right to use the underlying asset is conveyed on an installment basis.

Other-than-finance lease – A lease transaction in which the financing element is not considered significant. The profit or loss pattern of an other-than-finance lease is characterized by straight-line recognition.

The Boards plan to develop a principle and related indicators to distinguish the two types of leases.

In a finance lease, a lessee would record a right-of-use asset and corresponding liability. The liability would be amortized using the effective interest method, like a mortgage, and the right to use asset would be amortized, similar to depreciating a fixed asset. This treatment is the same as what the Boards originally proposed in the original ED.

In addition, since the Boards have tentatively agreed that the second type of lease contract does not contain a significant financing component, they intend to deliberate alternative attribution and presentation models for the income statement. In other words, the Boards will consider whether "rent expense" should be presented in the income statement, as opposed to the amortization and interest expense which would be presented under a finance lease. The Boards will also further evaluate whether a straight-line pattern of recognition—as tentatively indicated in the working definition—would be more appropriate than the accelerated pattern that results from applying the effective interest method to the lease payment liability.

In short, the Boards believe financial statement users will benefit from different income statement models to differentiate in-substance purchases from other leases. Finance leases will signal that the lessee has purchased substantially all of the risks and rewards of a leased asset by reflecting interest expense for the significant financing component. Conversely, other-than-finance leases will indicate when a lessee hasn't substantively purchased the asset. But in all cases, a lessee will portray its rights and obligations under the lease by reporting a right-of-use asset and a lease payment liability on its balance sheet.

Shortly after the meeting, there were conflicting reports as to whether both types of leases would be recorded on the balance sheet, or whether only finance leases would create recognized assets and liabilities. We have now confirmed that the Boards continue to believe all leases should be recorded "on balance sheet," consistent with the ED.

For more information, contact Dick Larkin, Director, BDO Institute for Nonprofit Excellence℠, at dlarkin@bdo.com.

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CONTACT:

CHRIS ORELLA
Northeast Region
Partner – Healthcare, National Leader
New York, NY
212-885-8310 / corella@bdo.com

KAREN FITZSIMMONS
Mid-Atlantic Region
Partner – Healthcare
Bethesda, MD
301-634-4969 / kfitzsimmons@bdo.com

ALFREDO CEPERO
Southeast Region
Partner – Healthcare
Miami, FL
305-420-8006 / acepero@bdo.com

STEPHEN FERRARA
Central Region
Partner – Healthcare
Chicago, IL
312-616-4683 / sferrara@bdo.com

MIKE MUSICK
Southwest Region
Partner – Healthcare
Nashville, TN
615-493-5610 / mmusick@bdo.com

STEVEN SHILL
West Region
Partner – Healthcare, National Leader
Orange County, CA
714-668-7370 / sshill@bdo.com