11-1800-10052-2

STATE OF MINNESOTA

OFFICE OF ADMINISTRATIVE HEARINGS

FOR THE MINNESOTA DEPARTMENT OF HUMAN SERVICES

In the Matter of the Rate Appeal of Elim Homes, Inc.

RECOMMENDED ORDER GRANTING FACILITY'S MOTION FOR SUMMARY DISPOSITION AND DENYING DEPARTMENT'S MOTION FOR SUMMARY DISPOSITION

The above-captioned matter is pending before Administrative Law Judge Barbara L. Neilson pursuant to a Notice of and Order for Hearing and Prehearing Conference issued by the Deputy Commissioner of the Minnesota Department of Human Services on September 20, 1995, and the parties' cross-motions for summary disposition. The parties entered into a Stipulation of Facts, which was filed with the Administrative Law Judge on June 24, 1996. Briefs regarding the cross-motions were filed and oral argument regarding the motions was heard on August 21, 1996. The record with respect to the motions closed on August 22, 1996, upon receipt of a clarifying letter from the Provider which was requested by the Administrative Law Judge during the oral argument.

Steven J. Lokensgard, Assistant Attorney General, 445 Minnesota Street, Suite 900, St. Paul, Minnesota 55101-2127, appeared on behalf of the Department of Human Services ("the Department"). Samuel D. Orbovich, Attorney at Law, Orbovich & Gartner, Chartered, 710 North Central Life Tower, 445 Minnesota Street, St. Paul, Minnesota 55101, appeared on behalf of the Respondent, Elim Homes, Inc. ("Elim" or "the Provider").

Based upon all of the files, records, and proceedings herein, and for the reasons set forth in the accompanying Memorandum,

IT IS HEREBY RESPECTFULLY RECOMMENDED that the Provider's Motion for Summary Disposition be GRANTED and the Department's Motion for Summary Disposition be DENIED.

Dated this 24th day of September, 1996.

BARBARA L. NEILSON
Administrative Law Judge

NOTICE

This Report is a recommendation, not a final decision. The Commissioner of Human Services will make the final decision after a review of the record. The Commissioner may adopt, reject or modify the Findings of Fact, Conclusions, and Recommendations. Under Minn. Stat. § 14.61, the final decision of the Commissioner shall not be made until this Report has been made available to the parties to the proceeding for at least ten days. An opportunity must be afforded to each party adversely affected by this Report to file exceptions and present argument to the Commissioner. Parties should contact John Petraborg, Acting Commissioner, Minnesota Department of Human Services, Second Floor Human Services Building, 444 Lafayette Road, St. Paul, Minnesota 55155, to ascertain the procedure for filing exceptions or presenting argument. Pursuant to Minn. Stat. § 14.62, subd. 1, the Agency is required to serve its final decision upon each party and the Administrative Law Judge by first class mail or as otherwise provided by law.

MEMORANDUM

Elim Homes, Inc. ("Elim"), operates nursing homes in Fargo, North Dakota, and in Princeton, Watertown, and Milaca, Minnesota, as well as several other care facilities not involved in this appeal. Elim has a central corporate office that provides support and direction to the facilities. Elim also owns Elim Preferred Services, Inc. ("EPSI") which is a non-nursing, for-profit business enterprise that purchases capital equipment, medical supplies, and other supplies for the care facilities operated by Elim and outside companies. Substantially more than fifty percent of EPSI's revenue comes from sales to facilities not related to Elim.

Elim receives reimbursement from the Department for allowable costs incurred in providing care to Minnesota nursing home residents under the federal Medicaid Act, 42 U.S.C. § 1396a, and the State's Medical Assistance Program, Minn. Stat. Ch. 256B. The reimbursement rates at issue in this proceeding were set under Minn. Stat. § 256B.431 and Minn. Rules 9549.0010 through 9549.0080 ("Rule 50"). To receive medical assistance payments, nursing homes submit annual cost reports showing costs incurred during the reporting year, which generally runs from October 1 through the following September 30. Minn. R. 9549.0041, subp. 1. During desk audits, DHS auditors review the cost reports and supporting documentation. Minn. R. 9549.0020, subp. 19, and 9549.0041. The auditors allow, disallow, or reclassify costs reported on the provider's cost report and, based upon adjusted allowable costs, calculate a prospective per diem rate for a rate year running from July 1 through the following June 30. Minn. R. 9549.0041, subp. 11, 13. Providers may appeal specific audit adjustments after they receive the final rate notice. Minn. Stat. § 256B.50, subd. 1b. If the appeal is not resolved informally, the provider may demand a contested case hearing. Minn. Stat. § 256B.50, subd. 1h. In this case, Elim has appealed the desk audit payment rates established by the Department for rate periods beginning July 1, 1993, and July 1, 1994 (based upon cost reports for fiscal periods ending September 30, 1992, and September 30, 1993) on behalf of several non-profit nursing homes it operates in Minnesota. See Notice of and Order for Hearing and attachments thereto.

Both the Department and Elim have filed motions for summary disposition in this matter. Summary disposition is the administrative equivalent of summary judgment. Minn. Rules pt. 1400.5500(K). Summary judgment is appropriate where there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. Sauter v. Sauter, 70 N.W.2d 351, 353 (Minn. 1955); Louwagie v. Witco Chemical Corp., 378 N.W.2d 63, 66 (Minn. App. 1985); Minn. R. Civ. P. 56.03. In considering motions for summary disposition, the Office of Administrative Hearings has generally followed the summary judgment standards developed in judicial courts. See Minn. Rules pt. 1400.6600.

It is well established that, in order to successfully resist a motion for summary judgment, the nonmoving party must show that specific facts are in dispute which have a bearing on the outcome of the case. Hunt v. IBM Mid America Employees Federal Credit Union, 384 N.W.2d 853, 855 (Minn. 1986). The existence of a genuine issue of material fact must be established by the nonmoving party by substantial evidence; general averments are not enough to meet the nonmoving party's burden under Minn. R. Civ. P. 56.05. Id.; Murphy v. Country House, Inc., 307 Minn. 344, 351-52, 240 N.W. 2d 507, 512 (1976); Carlisle v. City of Minneapolis, 437 N.W.2d 712, 715 (Minn. App. 1988). Summary judgment may be entered against the party who has the burden of proof at the hearing if that party fails to make a sufficient showing of the existence of an essential element of its case after adequate time to complete discovery. Id. To meet this burden, the party must offer "significant probative evidence" tending to support its claims. A mere showing that there is some "metaphysical doubt" as to material facts does not meet this burden. Id.

The only issue presented for resolution in this cost appeal is the proper allocation of central office costs between Elim's Minnesota nursing homes and EPSI. Based upon the memoranda, affidavits, and Stipulation of Fact filed by the parties, there appear to be no relevant facts in dispute regarding this issue. The parties disagree over whether the cost of goods purchased by EPSI for resale constitutes "operating costs" for the purpose of calculating the allocation of central office costs.

Minn. Stat. § 256B.432 (1994) sets out the allocation requirements for central office costs. Where a facility has a qualifying central office, any costs that can be directly identified to any nursing facility or other activity first must be allocated to that facility or activity. Id., subds. 3 and 4. Any allowable central office costs remaining after the costs that can be directly identified have been allocated must be allocated between the nursing facility operations and non-nursing facility operations based on a ratio of "total operating costs." Id., subd. 5(a). The formula to be used in the ratio is contained in Minn. Stat. § 256B.432, subd. 5(b) and (c). The numerator of the ratio is determined under subd. 5(b)(1)-(4), which sets forth four different options depending on the degree of relation between the nursing and non-nursing facilities and the type of activity engaged in by the businesses controlled by the central office. After this calculation, a further allocation is made between Minnesota facilities and non-Minnesota facilities based on their respective totals of resident days. Id., subd. 6(a). Once that allocable amount is determined, the statute requires that the amount be split among Minnesota facilities based on comparative resident days. Id., subd. 6(b).

The parties agree that the central office cost allocation is required and they agree on the particular formula for the ratio of nursing to non-nursing activities. The single point on which the parties disagree is what amount is properly characterized as the "total operating costs" of EPSI, a non-nursing home enterprise, for use in the allocation ratio. The particular statutory provision involved in calculating the numerator provides that, "for a central, affiliated, or corporate office providing goods or services to related organizations that are not nursing facilities, the numerator of the allocation ratio shall be equal to the sum of the total operating costs incurred by the non-nursing facility related organizations . . . ." Minn. Stat. § 256B.432, subd. 5(b)(2) (emphasis added). The statute indicates that the denominator to be used in the ratio is the sum of all of the numerators derived from application of subd. 5(b)(1)-(4). This ratio of total operating costs is then applied to allocate the remaining costs to each nursing and non-nursing activity. The larger the numerator for a non-nursing facility, the more the central office costs are allocated to the non-nursing activity and the less the central office costs are allocated to nursing-related facilities, resulting in a lower eventual reimbursement from the Department. The parties have stipulated that the percentages of central office costs allocable to non-nursing home enterprises if the cost of goods sold is included as an operating cost of EPSI are 10.05% and 15.56% in the first and second desk audit periods, respectively. Joint Stipulation of Fact, at 1-2. If the cost of goods sold is not included as an operating cost of EPSI, the percentages are 5.86% and 7.41%, respectively. Id.

In preparing its annual cost reports during the years at issue in this proceeding, Elim calculated the central office cost allocation formula under Minn. Stat. § 256B.432 using an operating cost figure for EPSI that was taken from its financial statements. This figure did not include the "cost of goods sold" by EPSI. On desk audit, the Department rejected Elim's operating cost figure for EPSI and replaced it with an amount that included all EPSI costs with the exception of property costs. The Department maintains that the "total operating costs" of EPSI must include the costs of goods sold by EPSI.

Elim argues that product costs (I.e., the cost of goods sold) merely flow through EPSI and do not reflect the cost or effort necessary to sell its products. Elim asserts that such costs are not deemed operating costs of EPSI under generally accepted accounting principles and generally accepted auditing standards. The Facility contends that Minn. Stat. § 256B and the rules promulgated by the Department thereunder do not support the approach taken by the Department during the desk audit and that the Department is attempting in this case to enforce an unpromulgated rule. Because the statute and rules are silent with respect to whether the cost of goods sold should be included in the operating costs of a non-nursing facility such as EPSI, Elim argues that the accepted accounting treatment of such costs should prevail.

In support of its position, Elim provided an affidavit from Konrad E. Gunderson, an audit and accounting consultant employed by Larson, Allen, Weishair & Co. See Affidavit of Samuel D. Orbovich, Ex. A. Mr. Gunderson has taught accounting courses at Augsburg College and The University of St. Thomas since 1993 in the areas of accounting principles, intermediate financial accounting, management accounting, and

current accounting topics and issues. He also taught accounting principles, accounting systems, auditing, and corporate finance between 1987 and 1989 at Loras College and Luther College. Mr. Gunderson attested that he had reviewed the cost report information pertaining to Elim Care, Inc., and the process used by Elim for allocating the costs of its central, affiliated, or corporate offices under Minn. Stat. § 256B.432. In his opinion, the cost of goods sold of EPSI should be excluded from the total operating costs used for the purpose of calculating the central office costs allocation ratio under the statute.

Several reference materials are attached to the Gunderson affidavit. These materials indicate that a distinction is made in the field of accounting between "period costs" and "product costs." Id., Exs. 1-4, 6. Period costs are operating expenses which are incurred to obtain benefits that are generally exhausted in the period in which the costs are incurred. Statement of Financial Accounting Concepts No. 6 - Elements of Financial Statements (The Financial Accounting Standards Board, Dec. 1985), Ex. 2 to Gunderson Affidavit at 51. Period costs include "all selling and administrative expenses. Therefore, advertising, executive salaries, sales commissions, public relations, and other nonmanufacturing costs . . . would all be period costs, and they will appear on the income statement as expenses in the time period in which they are incurred." Managerial Accounting, Seventh Edition, by Garrison and Noreen (Richard D. Irwin Publishing Co., 1994), Ex. 3 to Gunderson Affidavit at 37; see also Management Accounting, 9th Edition, Horngren and Sundem (Prentice Hall Publishing Co., 1993), Ex. 4 to Gunderson Affidavit at 120. In contrast, product costs are "the costs involved in the purchase or manufacture of goods. . . . Product costs are viewed as 'attaching' to units of product as the goods are purchased or manufactured, and they remain attached as the goods go into inventory awaiting sale. At the point of sale, the costs are released from inventory as expenses (typically called cost of goods sold) and matched against sales revenue." Id. Such costs are generally "treated as expenses in the time period in which the related products are sold" rather than as expenses in the time period in which they are incurred. Id. In merchandising companies, "the cost of goods sold simply consists of the purchase cost of the goods from a supplier." Id. at 39.

An example of an income statement of a merchandising company which appears in the Managerial Accounting text includes on separate lines the "cost of goods sold" (beginning inventory plus purchases to determine goods available for sale, minus ending inventory to arrive at gross margin) and "operating expenses" (selling expenses and administrative expenses). Id. Consistent with these reference materials, the financial statement of EPSI for the years ended Sept. 30, 1992, and 1993, reports on separate lines the "cost of goods sold" (or product costs) and "operating expense" (or period costs). Gunderson Affidavit, Ex. 5. Elim thus argues that the costs of good sold should not be considered an operating cost of EPSI pursuant to generally accepted accounting principles and generally accepted auditing standards. Elim asserts that it is period costs that reflect the size, scope and complexity of a wholesaler/retailer business such as EPSI, not product costs which merely flow through the organization. Elim's Answers to Interrogatories at 3-4 (Orbovich Affidavit, Ex. E).

The Department has not provided any affidavit disputing Mr. Gunderson's opinion regarding the proper application of generally accepted accounting principles and generally accepted auditing standards or filed excerpts from other textbooks contradicting those supplied by Elim. Rather, the Department argues that its interpretation of Minn. Stat. § 256B.432 to require the inclusion of the cost of goods sold in "total operating costs" is a reasonable construction of the statute under Cable Communications Board v. Nor-West Cable Communication Partnership, 356 N.W.2d 658 (Minn. 1984). The Department asserts that its interpretation is consistent with the legislative history of the statute and that there is no basis for applying the alleged GAAP definition.[1]

The Department asserts that, pursuant to the statutory scheme in place during the reporting years at issue in this case, all costs incurred by a nursing facility were either considered to be operating costs or property-related costs. The statute defines "operating costs" in the context of nursing homes as follows:

> "Operating costs" means the day-to-day costs of operating the facility in compliance with licensure and certification standards. Operating cost categories are: nursing, including nurses and nursing assistants training; dietary; laundry and linen; housekeeping; plant operation and maintenance; other care-related services; medical directors; licenses, other than the license fees required by the Minnesota department of health; permits; general and administration; payroll taxes; real estate taxes, license fees required by the Minnesota department of health, and actual special assessments paid; fringe benefits, including clerical training; and travel necessary for training programs for nursing personnel and dietitians required to maintain licensure, certification, or professional standards requirements.

Minn. Stat. § 256B.421, subd. 8. The Department contends that, pursuant to this statutory scheme, "[a]lmost every cost a facility incurs is a 'day-to-day cost of operating the facility" and that "the only costs not considered operating costs are property-related costs." Department Memorandum at 9. "Property-related costs" are defined in Minn. Stat. § 256B.431, subd. 3, to include depreciation, interest, earnings or investment allowance, lease, or rental payments, and in Minn. Stat. § 256B.431, subd. 3a, to include the rental use of real estate and depreciable equipment. The Department argues that the depreciation, amortization, and interest costs reported on EPSI's financial statements would be considered property-related costs in the context of this statutory scheme and that the remaining costs, including the cost of goods sold, must be considered operating costs in the context of Chapter 256B since they "are not property-related costs but are day-to-day costs of operating a business." Id.

As the Department acknowledges, Minn. Stat. § 256B.421, subd. 8, defines operating costs that a nursing facility would incur, not a non-nursing facility such as EPSI, and no provision of the relevant statutes or rules defines operating expenses for non-nursing home enterprises for the purpose of allocating central office costs among nursing facilities and non-nursing home enterprises. See Department's Answers to

Appellant's Request for Admissions at 2, attached to the Orbovich Affidavit as Ex. B. In fact, the statutory provision explicitly describes operating costs as "the day-to-day costs of operating the facility." (Emphasis added.) EPSI is not a nursing home facility. The definition of "operating costs" contained in Minn. Stat. § 256B.421, subd. 8, does not suggest in any way that the cost of goods sold by a merchandising organization must be included among its operating costs. The nature of a nursing facility's business enterprise is completely different from that of a merchandiser. Maintenance of inventory is not a day-to-day cost of a merchandising enterprise, as would be paying salaries or utilities. In short, there is nothing in the statutory definition of "operating costs" which addresses or governs the issue presented in this matter. Moreover, contrary to the Department's argument, the cost of a merchandiser's inventory is more closely akin to a property-related cost than a care-related cost.[2]

The Department maintains that its interpretation of "total operating costs" merely effectuates the intent of the Legislature in adopting the statutory requirement that central office costs be allocated based on a ratio of "total operating costs" rather than "expenses." In support of this argument, the Department cites a discussion between legislators and a Departmental witness during a meeting of the Omnibus Health Care and Family Services Funding Conference Committee. Department Memorandum at 10. The quoted discussion merely indicates that the reason for the amendment had to do with the belief that it would not be appropriate for expenses incurred in the development of an assisted living facility that were not directly related to nursing home operations to be applied to the operating cost area. Id. There was no mention during this discussion of inventory or the proper treatment of the cost of goods sold in the allocation formula. The quoted legislative history does not support the Department's interpretation of the statute.[3]

The fact that the costs to be included in the ratio under the Department's approach include overlapping costs of related organizations provides further evidence that the approach urged by the Department was not intended by the statute. As the Department admitted (see Department's Answers to Appellant's Request for Admissions at 2, attached to the Orbovich Affidavit as Ex. B), the inclusion of the cost of goods sold in the total operating expenses figure causes an overlap in the figures included in the denominator of the allocation ratio. The overlap occurs because the denominator includes not only the cost of a product when first acquired as an inventory product by EPSI but also includes the cost of the same product when purchased by a related nursing home enterprise. This practice inflates the denominator in the allocation formula and defeats the fair allocation which is the purpose behind the statutory formula. [4]

Relevant case law establishes that agencies are permitted to apply a statutory interpretation which "merely restates existing policy, or is consistent with the regulation it implements." Cable Communications Board v. Nor-West Cable Communication Partnership, 356 N.W.2d 658, 667 (Minn. 1984); see also Wacha v. Kandiyohi County Welfare Board, 242 N.W.2d 837, 839 (Minn. 1976) (an agency statement which merely summarizes existing law and does not create new requirements or restrictions is not an unpromulgated rule). The Department's interpretation of "total operating costs" with

respect to EPSI does not meet this standard. The Department's approach is not consistent with the statutory or regulatory scheme and is not a permissible interpretation of the statutory term. Neither the statute nor the rules address what should be included in the operating costs of a non-nursing facility. The only definition of "operating costs" is restricted to the unique characteristics of nursing facilities and has nothing to do with non-nursing home enterprises. Elim has established that the exclusion of the cost of goods sold from operating costs is consistent with generally accepted accounting principles and generally accepted auditing standards. The approach urged by the Department is at odds with such accounting industry standards which, under applicable law, are to be applied where rate-setting statutes and rules are silent on a particular point. See Minn. Stat. § 256B.48, subd. 2(a); Minn. Rules pt. 9549.0041, subps. 1, 6, 8 (1993).

There are no genuine issues of material fact to be resolved in this matter. Based upon the foregoing analysis, the Administrative Law Judge concludes that Elim is entitled to judgment in this matter. The Administrative Law Judge recommends that Elim's Motion for Summary Disposition be GRANTED and the Department's Motion for Summary Disposition be DENIED.

B.L.N.

March 19, 1996

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RE: In the Matter of the Rate Appeal of Elim Homes, Inc.; OAH Docket No. 11-1800-10052-2

Dear Counsel:

Enclosed and served upon you is a copy of the Administrative Law Judge's Third Prehearing Order in the above-entitled matter.

Yours very truly,

BARBARA L. NEILSON
Administrative Law Judge

Telephone: 612/341-7604

BLN:lr
Enclosure

STATE OF MINNESOTA)
) ss
COUNTY OF HENNEPIN)

AFFIDAVIT OF SERVICE BY U.S. MAIL

LaVon Regan, being first duly sworn, hereby deposes and says that on the 19th of March, 1996, at the City of Minneapolis, county and state aforementioned, she served the attached THIRD PREHEARING ORDER OF THE ADMINISTRATIVE LAW JUDGE; OAH DOCKET No. 11-1800-10052-2, by depositing in the United States mail at said City of Minneapolis, a true and correct copy thereof, properly enveloped, with first class postage prepaid and addressed to the individuals named herein.

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LaVon Regan

Subscribed and sworn to before me
this 19th day of March, 1996.

Notary Public

[1] The Department is not applying a long-standing interpretation in the present case. The Department admits that the adjustments at issue in this case mark the first time that the costs of goods sold by a non-nursing home enterprise have been included in its operating expenses to calculate the denominator of the central office cost allocation ratio under Minn. Stat. § 256B.432. See Department's Answers to Appellant's Request for Admissions at 2, attached to the Orbovich Affidavit as Ex. B. The Department maintains, however, that the calculation under the statute prior to its amendment in 1993 included the cost of goods sold because the statute then referred to "total expenses" and there thus was no distinction between operating and non-operating expenses. Id.

[2] During oral argument, the Department, using the example of a package of diapers, argued that such an item is not easily conceived of as property-related. In the nursing home enterprise, the Department's assertion has merit, since a package of diapers would be used and discarded, resulting in an expense to the nursing home facility. In the case of a merchandiser, however, the item is not used but instead is sold, resulting in revenue. Indeed, the item will, in the normal course of business, create more in revenue than the item cost to purchase. The cost of the item in the context of a merchandiser is not an "expense" as it might be in the nursing home business, where it is purchased and consumed.

[3] Elim argues that the cost allocation formula set forth in Minn. Stat. § 256B.432 is designed to divide the costs of a central office fairly between enterprises entitled to reimbursement and enterprises outside the reimbursement system and thereby allocate costs in a fair manner among related organizations. The Department responded that "[t]his could very well be the purpose, but it is not explicitly stated in the statute. The rule could be designed in a way which shifts costs from nursing facilities to non-nursing facilities in order to encourage a central office to directly identify its costs." Department Memorandum at 11-12. Contrary to the Department's argument, there is no evidence in the statutory scheme that the cost allocation method is intended to promote the direct identification of costs. Such encouragement would be more easily provided by disallowing or reducing the percentage of allowable costs not directly identified prior to any allocation. The purpose of the statute is to reimburse only the reasonable and necessary expenses of nursing homes in providing care to eligible residents. Allocation of non-nursing home costs merely fulfills that purpose. There does not appear to be any hidden incentive program in the central office cost allocation statute.

[4] The Department argues that it is necessary to compare similar costs to fairly allocate costs among related organizations under Minn. Stat. Chap. § 256B. The Department criticizes Elim's position as excluding areas of operating costs for non-nursing facilities that would otherwise be included for nursing facilities. It urges that a common definition of "total operating costs" be applied to both nursing facilities and non-nursing facilities and asserts that there is no basis for applying the alleged GAAP definition urged by Elim. As discussed above, the definition of operating costs in Minn. Stat. § 256B.421, subd. 8, simply does not apply to non-nursing facilities. The list of cost areas that the Department maintains would have to be excluded from the definition of "operating costs" for nursing facilities under Elim's approach are expressly included in that definition by statute. Moreover, all of these cost areas involve direct services to residents or maintenance of the facility in which those residents live. There are no analogous services or maintenance expenses involved in a merchandising organization's sale of goods to a nursing facility. None of the cost areas specified in Minn. Stat. § 256B.421, subd. 8, includes the cost of goods sold. A fair comparison of economic activity between business enterprises must take into account the differences between those enterprises.