COST REPORTING

Medicare and Accrual Basis Accounting

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If you are like many home care executives, you are familiar with the concept of "accrual-based accounting;" however, you may not be as familiar with the essential details. All too often, we find people wondering why they need to use accrual-based accounting. Some wonder what "accrual" is and how it works. Many home health agencies become equally concerned at the end of their fiscal year about what they can do to ensure compliance with accrual requirements. If you feel like you would benefit from more detail on accrual-based accounting, you are not alone! Let's review the difference between accrual and cash basis accounting in an effort to demystify the process and underscore the importance of your accounting methods.

Let's start with the basics. When you entered the Medicare system, you agreed to abide by the Conditions of Participation. One of these conditions is to use the accrual basis of accounting for cost reporting.

> **Medicare Requirements:**
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> Provider Reimbursement Manual (CMS-Pub. 15-1) §2300. PRINCIPLE
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> Providers receiving payment on the basis of reimbursable cost must provide adequate cost data based on financial and statistical records that can be verified by qualified auditors. The cost data must be based on an approved method of cost finding and on the accrual basis of accounting.
>
> §2302.1 Accrual Basis of Accounting
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> Under the accrual basis of accounting, revenue is recorded in the period when it is earned, regardless of when it is collected, and expenditures for expense and asset items are recorded in the period in which they are incurred, regardless of when they are paid.

Most people are innately familiar with the cash basis of accounting, but accrual basis is foreign to many. When you receive a payment, you have revenue; when you pay a bill, you have an expense. This is a simple and logical way of seeing the business world. This is "cash basis accounting."

Accrual-based accounting is different – it is essentially a means of matching expenses with the revenues they generate. To accomplish this, one must "recognize" the revenue and expenses in the period they are "realized." To "recognize" revenues or expenses simply means to record them in the books. One "realizes" revenues or expenses when they occur, or when you find out about them.

An example – We can use our daily bills as a means of illustrating the difference between the cash and accrual basis of accounting. If you use QuickBooks, this example will be particularly useful!

> **Cash Basis Accounting**:
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> QuickBooks' commercials say, "If you can write a check, you can use QuickBooks." This statement is true, if one uses the cash basis of accounting. The bill is received, the check written, and payment mailed to the vendor. This is the process of operating on a cash basis.

Accrual-Based Accounting:

Carrying the QuickBooks example forward, you are using accrual-based accounting when starting with the “Enter a Bill” feature. You begin by entering the date on the bill (or better yet the period to which the bill relates) and then use the “Pay Bills” feature to write the checks when payment is due. Using this method, you have recorded the expense in the period in which it was incurred, thus “realizing” the expense according to the accrual method.

In the above accrual example, you also recorded an associated liability – “accounts payable” in this case. To put it simply, a liability is a debt. There are a couple types of liabilities:

Current liabilities are due within one year such as accounts payable, payroll and payroll tax liabilities.

Long-term liabilities are more than a year in term such as notes, loans or leases.

Recognizing, or the recording of, revenue is a more difficult concept for many to understand – especially when dealing with the Medicare system. The accrual basis of accounting means that you need to recognize (record) revenue when it is earned, not when payment is received. An episode of care under PPS can cover three different months (for example, an episode that begins January 17 can cover January, February, and March). The accrual basis requires that a portion of this revenue be recognized (recorded) in each of these months.

One method of recognizing revenue is the 60-day method. Using this approach, one would recognize one-sixtieth (1/60) of the HHRG amount for each day of the episode of care. For example: if an episode begins on January 17 and has an HHRG payment of $5,000, you would use the following calculations:

January: Recognize $1,250 of revenue (15 days in January [don’t forget to count the first day] divided by 60 days times $5,000 [15/60 X $5,000]).

February: Recognize $2,333.33 (28 days {29 days in 2008} divided by 60 days times $5,000 [28/60 X $5,000]).

March: Recognize $1,416.67 (17 days in March divided by 60 days times $5,000 [17/60 X $5,000]). More simply, you would recognize $5,000 less the $3,583.33 ($1,250 + $2,333.33) that you recognized in January and February.

You are probably wondering what happens when an episode is not a “Full Episode” (LUPA, PEP, etc.)? In these cases, you recognize (record) any adjustment in the period they are realized (discovered, or when the episode ends). An Example: If on February 2 in the above-described episode of care, the episode ends with only 4 visits (a LUPA) and a LUPA payment of $500, you would recognize a reduction of $750 in revenue (-$750) in February ($500 in earned revenue for the episode less $1,250 recorded in January).

Another Example: If the same example as above lasts the full 60 days but fails to meet the planned therapy visit plan and yields an HHRG payment of only $3,000, you would recognize a reduction of $583.33 of revenue in March (-583.33) ($3,000 less $3,583.33 previously recognized in January and February). Nobody said that dealing with Medicare was easy!

The other side of the revenue entry is "accounts receivable." Accounts receivable is used to record monies that are owed – the opposite of accounts payable. Continuing with the example above… Example: At the end of January, you would record $1,250 in revenue (the amount that was earned) and $1,250 in accounts receivable. Assuming the example episode is a full episode and you are paid in April, you would record the deposit of $5,000 to the bank in April and offset the accounts receivable $5,000 ($1,250, $2,333.33, and $1,416.67 recognized in January, February, and March respectively), thus zeroing out the accounts receivable for this episode.

> **LUPA Example:** In the LUPA example above, you would record $1,250 in revenue and accounts receivable at the end of January, and reduce revenue and accounts receivable $750 (-$750) in February. These entries will result in $500 net revenue and $500 in net accounts receivable for the episode. When payment is received, you would deposit the $500 payment to the bank and offset the $500 remaining in accounts receivable.

RAP payments add another level of difficulty when dealing with Medicare. A RAP payment is not considered revenue until it is earned. The simplest method of dealing with RAP payments is to use a liability account (you have the money but must pay it back – the RAP reversal). Continuing the above example…

> **Example:** When the RAP is paid, you would deposit $3,000 (60% of $5,000) in the bank and offset a liability account (Unearned Revenue, RAP Payment, etc.). Remember, you must modify the above example for the final payment to take into account the RAP payment. To do so, you would record a deposit of $2,000 to the bank ($5,000 less the $3,000 RAP reversal), $3,000 to the liability account (to record the RAP reversal), and $5,000 to accounts receivable (to record payment for episode).

The entry to record revenue can be done monthly; however, entries to record RAP and final payments must be performed each time a payment is received and monies are deposited in the bank. The payments can be recorded in total because the total RAP payment, RAP reversal, and final payment will equal the bank deposit.

Other expense and liability accounts that need to be addressed include Capital Assets and Depreciation. The principle here is to match expenses to the revenue they generate.

> **Example:** Let's say you buy a delivery van, which will help generate revenue for several years. In this scenario, the cost of the van will need to be expensed over the entire period that it will help generate revenue. The recognition of this expense is called Depreciation. Capitalized assets are recorded on the books as an asset at their initial cost. Each period (monthly or annually), a portion of this amount is expensed and the net value of the asset is reduced.

Payroll also causes problems for those that are new to accrual-based accounting. This is partially because the IRS (and many payroll systems) uses the cash basis.

> **Example:** To illustrate, let us assume that your payroll period ends on the 15th and the 28th/29th/30th/31st (the last day of the month), and you pay your employees on the 10th and 25th. Accrual-based accounting requires that you record these expenses on the day the payroll period ends (15th and last day of the month) and offset these expenses to a liability account (such as "Wages Payable" and "Payroll Taxes Payable"). When you pay your

employees, you would then offset these liabilities. These entries may be complicated and too time consuming for you to perform each pay period, but they must be done at the end of your fiscal year for cost reporting purposes.

Payroll taxes pose yet another challenge. Many people record the payment for payroll taxes withheld from employees' wages as payroll tax expense. We will use the following example to illustrate the correct method.

> **Example:** Let's assume that you pay an employee $20 per hour to work 80 hours in a pay period with $400 withheld for taxes resulting in a net check of $1,200. You would record $1,600 in wage expenses (not $1,200) and nothing for payroll tax expenses -the $400 is not your expense, it was withheld from the employee and represents a liability (you currently have the money but need to pay it to taxing authorities). You do have payroll tax expenses in the form of Employer Taxes such as Employer Medicare, Employer Social Security, Federal and State Unemployment Tax, and possibly state and local taxes. These taxes are in addition to the Wages and Salaries, which include the amount withheld for taxes. In this case, you would have $1,600 in wages, approximately $160 in payroll taxes, and $1,760 in payroll liabilities.

Medicare does not require that agencies use accrual based accounting in day-to-day accounting; however, they do require that agencies use it for cost reporting. If you feel that you cannot maintain your books on an accrual basis, all is not lost! You can have a professional convert your cash-based books to accrual basis. Because of the inherent complexities, it is important to use someone who knows what they are doing in general and specifically for Medicare-certified home health providers.

Your chosen professional must be able to calculate how much revenue you have earned in the fiscal period. They need to determine how much is owed to you (accounts receivable). You need to provide them with a list of debts that were unpaid at year-end (accounts payable), as well as payroll records so that they can calculate the correct payroll expense and liabilities. They will also need to know what assets you own, when they were purchased, what you paid for them, and how much has previously been depreciated (your tax professional should have the information relating to cost and depreciation).

These are only the basics of accrual-based accounting, intended to help demystify this challenging aspect of financial management! If you use the methods we have outlined here, your books will reflect the amount of revenue that you have earned, how much money is owed to you, how much will be taken back when the episode ends, and how much you owe. Your expenses will be in the correct period and relate to the revenue they generate. Ultimately, this accrual-based accounting approach provides financial business intelligence to support solid management decisions.

Beyond business intelligence, Medicare requires that agencies use accrual-based accounting when preparing the cost report. This method is important to the government, as it reconciles expenses to the revenues they generate, thereby helping the government accurately assess the cost of providing Medicare services. It is not too late to comply with Medicare regulations! Whether you do it yourself or enlist professional help, we hope that this whitepaper gets you going in the right direction.

About Thomas E. Boyd

Thomas E. Boyd was appointed as Vice President of Reimbursable Services at Simione Healthcare Consultants in 2014, following 20 years as principal of Boyd and Nicholas, Inc., THE COST REPORT PEOPLE®, which he co-founded with Thomas Nicholas in 1993. Tom has more than 30 years of Medicare reimbursement experience, including almost 12 years with one of the Medicare intermediaries for home health agencies, and has been a consultant to Medicare-certified home health agencies and hospices since 1989.

Tom has spoken on home health financial and compliance issues before NAHC, NHPCO and more than 20 state and regional home health care associations.

He holds a B.A. in management and accounting from Sonoma State University, and a MBA from St. Mary's College in California. He is a member of the HHFMA workgroup, the Association of Certified Fraud Examiners, and the U.S. Chess Federation.

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