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Part 2

The material in this part of the Appendix covers the following topics:

- Developing indirect cost rates.
- Who reports what: How related organizations should report community benefit.

Developing indirect cost rates

Cost accounting systems assign indirect costs to programs based on sophisticated and highly detailed allocation techniques. In the absence of a cost accounting system, indirect cost factors can be derived from the Medicare Cost Report, or special studies conducted by the finance department can be used to incorporate these costs.

The cost factor or rate typically is expressed as a percentage:

(Total Indirect and Direct Costs)/Direct Costs – 1 = Indirect Cost Factor

The factor then is applied as follows:

Program Direct Costs × (1 + Indirect Cost Factor) = Total Community Benefit Expense

The following table provides recommendations for how indirect cost factors can be developed for each category of community benefit.

ACTIVITY OR PROGRAM	INDIRECT COST FACTOR
Financial Assistance	Indirect costs are included in the numerator of the "ratio of patient care cost to charges"; a separate indirect cost factor is not needed.
Medicaid and Other Means-Tested Government Programs	Indirect costs are included in the "ratio of patient care cost to charges," in an organization's cost accounting system or the program cost reports, so separate factors are not needed.
Community Health Improvement	Develop two indirect cost rates, one for community health initiatives that are sited at the hospital and a second for initiatives sited in non-hospital, community settings. • The "hospital-based" rate can be derived from Medicare Cost Reports or from an indirect cost model built into the hospital's cost accounting system. The Medicare Cost Report includes six categories of "cost centers" – General Service, Inpatient Routine, Ancillary, Outpatient, Other Reimbursable, Special Purpose (capital-related) and Non-Reimbursable. Indirect (overhead) costs are accounted for in two of these cost centers: "General Service" and "Special Purpose." An indirect cost rate can be calculated by summing the expenses for cost centers within each category, and then calculating the following ratio: Sum of General Service and Special Purpose Costs (Excluding Education-Related Cost Centers and the costs of Community Benefit Operations) Divided by Total Expense Education and community benefit operations costs are excluded from this rate because they are captured in full elsewhere in the accounting framework. Costs should be derived from Worksheet A, Column 5 of the Medicare Cost Report (which shows costs for each cost center after reclassifications).

ACTIVITY OR PROGRAM (continued)	INDIRECT COST FACTOR (continued)
Community Health Initiatives *(continued)*	• The "community-based" rate should be lower than the "hospital-based" rate and should exclude the costs of hospital buildings, the billing office, laundry and other cost centers that should apply only to hospital-based programs. If an organization has a cost accounting system, indirect costs can be determined for community health improvement and other services based on the allocations made by that system.
Community Benefit Operations	Community Benefit Operations is itself an overhead function. A reasonable indirect cost rate that accounts for space used by this activity and also for administrative oversight is appropriate.
Community-Building	See discussion for "community health improvement."
Subsidized Health Services	Organizations with a cost accounting system can rely on that system to derive total costs for each subsidized health service (direct and indirect costs). Organizations without a cost accounting system can develop a "hospital-based" rate from the Medicare Cost Report or from a special study.
Health Professions Education	The Medicare Cost Report (MCR) is a preferred source for indirect cost factors for health professions education activities. In the MCR, Worksheet B, Part I, column 0 includes the direct cost (before overhead) of programs for interns and residents, paramedical education programs and any nursing school programs. Columns later in Worksheet B show the total cost of these programs after indirect cost allocations.
Research	Indirect costs for research programs should be based on rules established by the National Institutes of Health (NIH). Some organizations include indirect costs based on amounts or factors they submit for approval. Others include these costs based on rates actually approved by NIH. The rate based on the amount submitted for approval is the most appropriate statistic for purposes of community benefit accounting, so long as the rate follows NIH cost-finding rules.
Financial and In-Kind Donations	This indirect cost rate should be minimal or zero, if the organization has separately accounted for the cost of the grant-making function as part of its community benefit operations.

CHA recommends having at least two indirect cost rates to be applied to community health initiatives and for community-building activities – one rate for "hospital-based" programs and a second, lower rate for programs that are "community-based."

- One program might be housed in hospital space (thus absorbing utilities, maintenance, and other costs) and for that program a higher, "hospital-based" rate would be appropriate.
- Another program may be based in a non-hospital community setting and rely much less on the hospital for support and administrative services and a lower "community-based" rate would apply.

If a cost accounting system is available, indirect costs can be allocated based on statistics that are unique to that type of cost. The following table shows the types of statistics used by one multi-hospital system to allocate indirect cost within its cost accounting system.

INDIRECT COSTS	ALLOCATION STATISTIC
Building depreciation and interest expense on debt	Square footage
Employee benefits that have not been directly assigned to activities or programs	Paid hours or salary expense
Human resources	Paid hours or salary expense
Materials management	Square footage or supplies expense
Hospital administration	Total expense
Finance and accounting	Total expense
Planning and marketing	Total expense
Information technology	Total expense
Communications	Total expense
Plant operations and maintenance	Square footage
Security	Square footage
Laundry	Pounds of laundry
Utilization review	Total expense
Quality management	Total expense
Nursing administration	Paid hours
Patient registration	Gross charges
Patient billing	Gross charges

INDIRECT COSTS (continued)	ALLOCATION STATISTIC (continued)
Medical records	Gross charges
Dietary and nutrition services	Meals served
Research	Total expense
Laboratory administration	Laboratory revenue
Radiology administration	Radiology revenue
Service lines administration	Revenue for each service line
Ambulatory clinic administration	Ambulatory revenue
Depreciation on equipment, patient care	Directly assigned to patient care departments based on fixed asset ledger
Employee benefits, patient care	Paid hours in patient care areas

Who reports what: How related organizations should report community benefit

Many health care organizations operate more than one corporate entity. Chapter 4 provides the following guidelines for how related organizations should report community benefit:

- If a hospital operates a foundation under the same federal Employer Identification Number (EIN), (e.g., foundation activities and hospital activities are "housed" in the same non-profit corporation), transfers of funds from the foundation to the hospital for community benefit activities will not be separately recognized or reported as they are "intracompany" transfers. When the hospital uses funds provided by the foundation for community benefit activities, it will report the associated expense on Schedule H as community benefit expense. If the funds received by the foundation were restricted by a third party they will need to be reported as direct offsetting revenue when used for a community benefit purpose.
- If the hospital and foundation activities are conducted by different related organizations, each with its own EIN (e.g., the foundation activities and hospital activities are operated in different non-profit corporations), transfers of funds from the foundation to the hospital for community benefit activities will be separately recognized and reported as they are "intercompany" transfers. In this case, the foundation will report the transfer of the funds to the hospital as an expense on its Internal Revenue Service (IRS) 990 Core Form and the hospital will report the receipt of such funds as grant revenue on its 990 Core Form. However, when the hospital uses such funds to support community benefit activities, it will report the associated expense in the appropriate column of the Community Benefit Table on its IRS Form

990, Schedule H for Hospitals (Schedule H). If the foundation has placed a restriction on how the funds are to be used, the hospital will need to report the transfer as direct offsetting revenue on Schedule H.

This demonstrates how these guidelines can be followed:

A foundation is controlled by the same system that controls the hospital. The foundation receives a restricted grant of $1,000,000 (intended to be transferred over two years), and then transfers $500,000 of the grant (pursuant to the restrictions) to a system hospital. The system hospital then uses the transferred funds pursuant to the restrictions and spends them to support a community benefit program that costs $600,000 during the year. As a result, the hospital is using $100,000 of its own funds to help finance the program.

The following table demonstrates how accounting and reporting should be handled both under GAAP (Generally Accepted Accounting Principles) and in Form 990, Schedule H. Note that the results under GAAP and Form 990 are the same.

	SEPARATE EIN REPORTS				CONSOLIDATED EIN REPORT	
	FOUNDATION		HOSPITAL			
A. GAAP						
Grant Revenue	$1,000,000	1	$500,000	3	$1,000,000	5
Total Community Benefit Expense	$500,000	2	$600,000	4	$600,000	6
Net Community Benefit Expense	$ 500,000		$100,000		$100,000	
B. 990 Accounting						
1. Amounts in Core Form Grant	$1,000,000		$500,000		$1,000,000	
Revenue Expense	$500,000		$600,000		$600,000	
2. Schedule H						
Direct Offsetting Revenue	NA	7	$500,000	8	$500,000	10
Total Community Benefit Expense			$600,000	9	$600,000	11
Net Community Benefit Expense			$100,000		$100,000	

GAAP accounting and reporting

Under GAAP, the following would occur. The superscripts reference examples on the chart.

If the foundation and the hospital are publishing *separate* community benefit reports:

- [1]The $1,000,000 raised by the foundation would be reported as revenue for that entity.
- [2]The $500,000 transferred by the foundation to the hospital would be included in the foundation's operating expense.

- [3]That same $500,000 would be reported as revenue by the hospital.
- [4]The hospital's community benefit program cost of $600,000 would be reported as part of its total community benefit expense.
- Net community benefit expense for the hospital would be the difference between [3]revenue and [4]expense, or $100,000.
- The two, separate, unconsolidated reports would have total combined revenue of $1.5 million[1, 3] and total community benefit expense of $1.1 million[2, 4].

If the foundation and the hospital were publishing a *consolidated* (e.g., system-wide) community benefit report, the "intracompany" transfer from the foundation to the hospital (the $500,000 amounts in italics[2, 4]) would not be recognized or reported (in accounting terms, it would be "eliminated").

- [5]Only the $500,000 originally raised by the foundation[1] and used by the hospital during the year for the designated community benefit purpose would be reported as revenue on the Schedule H.
- [6]Only the $600,000 community benefit program cost[4] incurred by the hospital would be reported as expense.

In this case, the foundation and hospital would not be considered separate entities for accounting purposes. The consolidated community benefit report would have $500,000 in direct offsetting revenue (the original amount received from the donors or grantors and actually used for the designated community benefit purpose during the year) and $600,000 in total community benefit expense (for the cost of the community benefit program). Net community benefit expense would be $100,000.

The values included in revenues and expenses reported in Form 990 are the same as those reported under GAAP.

Form 990, Schedule H

In Schedule H, the following would occur:

If the foundation and the hospital have *separate* (unique) EINs:

- [7]Schedule H would not be filed by the foundation.
- [8]The hospital would file Schedule H, but pursuant to IRS instructions, would not include the grant dollars transferred from the foundation and used for a community benefit purpose in "direct offsetting revenue."

- [9]The hospital's Schedule H would include the $600,000 cost to operate the community benefit program.
- Net community benefit expense would be $100,000, because the restricted grant dollars are to be included in "direct offsetting revenue."

If the foundation and the hospital share *the same* EIN:

- [10]Schedule H would not include any funds collected by the foundation from donors or grantors in direct offsetting revenue until those funds are used for their designated purpose(s).
- [11]The hospital's Schedule H would include the $600,000 cost to operate the community benefit program.
- Net community benefit expense would be $100,000, because the restricted grant dollars are to be included in direct offsetting revenue when used pursuant to the restriction(s).