

## ATTACHMENT II

### RATE SETTING GUIDELINES

#### I. Preparation for Rate-Setting

The goal of any rate setting strategy is to generate the revenues necessary to meet the costs of the provider of service, including any provision for retained revenue. This does not mean determining the highest possible rate or the lowest, but rather the rate that results in the provision of the most services based on provider capacity. The best rate can be found by identifying the demand for the service and by factoring in market competition. Before starting the process, it is important to make a detailed study of all costs involved. Costs should include direct and indirect costs plus a consideration of assets. There are several requirements that must be fulfilled before rate-setting can be done.

##### A. Accounting System

The provider must have an accounting system which identifies total costs. Management should make full use of the financial accounting system to separate costs into cost centers. The establishment of cost centers in the accounting system will minimize adjustments and allow expenses to be assigned directly to the appropriate cost center. Cost analysis must involve cooperation between a provider's fiscal and accounting staff, and administrators and managers. Consultation and agreement on the structure of the provider's accounts and the treatment of each type of cost will facilitate the allocation and recovery of costs.

##### B. Allowability of Costs

The tests of the allowability of costs are:

1. Compliance with the § 4300 regulations.
2. Compliance with the operating agreement.
3. Costs are based on arms length transactions (a transaction that is conducted as though the parties were unrelated, thus avoiding any semblance of conflict of interest).
4. The costs are necessary and proper for the operation of the program and the provision of services.
5. The costs are reasonable to the extent that they are of the same nature as expenditures which would be made by a cost conscious and prudent buyer in the marketplace.
6. The costs must be given consistent treatment through the application of generally accepted accounting principles.

##### C. Rate Development Considerations

1. Rates should be based on allowable costs.
2. Rates should include all costs which are essential to providing the service.
3. Indirect costs can only be recovered by including them in billable services.

4. Rates should be based on units of service and activities consistent with the standard service and unit definitions promulgated by the Office of Mental Retardation. For most services, only face-to-face time is a billable unit or activity.
5. Rate proposals must include staffing ratios that comply with licensing requirements and the needs of the individual as identified in the Individual Service Plan (ISP).
6. Rates must be net of income. The billed rate must match the rate in HCSIS. Offsetting the rate with income in a PROMISe claim could result in a mismatch. Private pay consumers must be backed out up front.
7. Providers may propose a site rate for residential services when it is anticipated that all persons residing in the home will incur services at an equivalent level and cost. For persons with special needs specified in their ISP, individual rates may be proposed by the provider. These individualized rates should include the site rate plus the additional costs associated with the special needs.
8. Typically, a rate should include all allowable costs necessary to provide the service divided by the number of service units anticipated to be delivered during the contractual term of the rate.

#### D. Basic Steps

1. List all the costs of the provider.
2. Identify the direct and indirect cost centers of the provider.
3. Assign allowable costs to the cost centers.
4. Allocate allowable costs of the indirect cost centers to the direct cost centers.
5. Calculate unit costs by dividing the total allocated costs of each direct cost center by the units of service projected to be provided.

## II. Assignment and Allocation of Costs

### A. Direct and Indirect Costs

Direct costs are defined as costs that can be identified and immediately charged to a specific cost or service category.

Indirect costs are defined as costs incurred for a common or joint purpose and not readily assignable to a specific cost or service category.

### B. Provider Cost Centers

Determining the cost centers within the provider is basic to rate setting. A cost center is defined as an organizational component or activity into which costs can be grouped. Each cost center must be designated as a direct or indirect cost center. The number of cost centers chosen may vary depending on the size and complexity of the provider and the specific types of services it provides.

Direct cost centers in most cases will be based on standard service definitions.

Regardless of number, cost centers should be chosen to accurately reflect the essential components of the provider.

### C. Data Needed for Rate-Setting

The provider should make a list of the information needed for rate-setting. The information should be collected prior to rate-setting. The following are some examples of what may be needed:

- a. Personnel activity reports (or other data for allocating salaries, wages, and benefits to cost centers)
- b. A space survey to determine net assignable square feet by function (cost center/service)
- c. Historical service utilization by person and/or program and/or units of service
- d. Past audits
- e. Cost allocation plan
- f. Documentation of costs
- g. Documentation of other revenue sources

### D. Assignment of Costs to Cost Centers

The first step in rate setting is to collect cost and statistical data from financial accounting records and other sources. These data are used to prepare an initial listing of expenses where the accumulated costs are listed by object of expenditure. The listing must be detailed enough to allow accurate assignment of the associated costs to services and cost centers. The detail required will depend largely on the specific identification of cost centers.

Once the initial expense listing has been prepared, the total costs are assigned to the appropriate cost centers.

Some costs can be assigned directly to cost centers. Direct assignment of a cost to a cost center should be done where possible. In some cases, additional data are required to develop proportional assignment.

### E. Allocation of Indirect Costs

Indirect cost centers are those that benefit multiple direct cost centers. The allocation of costs recognizes that indirect cost centers support services and direct cost centers. Such allocations are needed to determine the total cost of each service. There must be a rational basis to support the allocation of each indirect cost center.

There is no general rule for classifying costs as direct or indirect. A cost may be direct with respect to a specific service or organization, but indirect with respect to another. Once classified, each cost should be treated consistently either as a direct or indirect cost.

The overall objective of the allocation process is to distribute the indirect costs of the provider to its various cost centers in reasonable proportion with the benefits provided to these cost centers.

The apportionment of indirect costs may be treated in two ways:

1. Indirect costs may be specifically identified and apportioned into the direct cost of services provided. These costs become a direct cost when properly identified, documented and allocated.
2. Indirect cost pools or centers may be established to accumulate expenditures. These costs may be distributed to service or cost categories based on a rate identified in the cost allocation plan. A line item may be identified for indirect costs for each service or cost category.

Distributing indirect costs to the appropriate services requires the development of an allocation methodology. The methodology should logically apportion costs among services receiving a benefit. The methodology should result in the fair and equitable distribution of costs in direct relation to the actual benefits accruing to the services to which costs are charged.

Certain activities are not allowable costs for inclusion in the service rate. However, these unallowable costs should be treated as direct costs for purposes of determining indirect cost rates and be allocated their share of the provider's indirect costs.

F. Determination of indirect cost rates (see the Federal Office of Management and Budget [OMB] Circulars A-122 and A-87 for more details)

1. "Simplified Allocation" method

This method is used when the major functions of the provider benefit in approximately the same degree from the indirect costs. Under this method, the provider's total costs for the base period are separated into direct and indirect costs. Then the provider's total allowable indirect costs are divided by an equitable distribution base. The result is a percentage rate used to distribute indirect costs.

The distribution base may be total costs (excluding capital costs and other distorting costs), direct salaries and wages, or other base, which result in an equitable distribution.

2. "Multiple Allocation Base" method

This method is used where a provider's indirect costs benefit direct cost centers in varying degrees. Indirect costs are accumulated into indirect cost centers and allocated individually to benefiting cost centers by means of an appropriate base. Indirect cost centers include:

- a. Depreciation
- b. Interest

- c. Operation and maintenance expenses: This includes costs incurred for the administration, operation, maintenance, preservation, and protection of the provider's physical plant.
- d. Administration and general expenses: This includes costs incurred for the overall general executive and administrative offices of the provider and other expenses of a general nature which do not relate solely to any function or service.

The allocation base that best assigns indirect costs to services receiving a benefit should be the one selected.

Indirect cost centers consisting of depreciation, interest, operation and maintenance, and administration and general expenses are allocated in that order to the remaining direct and indirect cost centers. Other indirect costs could be allocated in the order determined to be most appropriate.

An indirect cost rate is determined for each indirect cost center. The rate is the percentage of the amount of a particular indirect cost center to the base identified for that indirect cost center.

### 3. "Direct Allocation" method

Except of general administration and general expenses, it may be possible to treat all costs as direct costs. In such cases, joint costs are prorated individually as direct costs to each cost center using a base most appropriate to the particular cost.

## III. Determination of Unit Costs

The final step in the process is to determine the total output of each service expressed in service units. The total costs of each service are divided by the total projected output of the service to determine unit costs (total cost divided by chargeable units = unit cost).

Productivity is a primary factor in determining projected output. Productivity for a staff person is the number of hours billed divided by the number of hours paid for a given period.

No shows and cancellations can be minimized by involving families and supports coordinators.

There are several ways in which utilization can be used in rate setting. It can be used in authorizing services for an individual. It can be used in the aggregate for calculating a rate for a service.

### Use of Unit Costs and Other Cost Analysis Information

Unit costs are used as a basis to set rates for cost recovery. Other information derived from cost analysis can help in financial management. The true cost of providing a unit of service will assist provider management in determining its position in the marketplace.

#### **IV. Unit of Service Considerations**

- A. In developing utilization factors for rate setting, utilization for the prior five years must be documented and used.
- B. Productivity factors are influenced by the size of the unit used. Smaller units may result in bills being rejected because it may be more difficult to accurately project the number of units that will be provided.
- C. The larger the unit, the larger the utilization rate (when the utilization rate is the number of units that the provider is expected to deliver - 90%, 95%, etc.). Also, there is less potential for problems with available units when larger unit definitions are used.
- D. The one-half month and month units for residential services consider vacancy rates in the definitions.
- E. One method for considering utilization is to know the utilization history of each person and authorize services for that person based on history. This requires active management and adjustments because utilization is tied to the individual. This method takes a step toward defining need in that use reflects what a person needs. Another more commonly used method is to apply a vacancy factor to the total (aggregate) number of units projected to be delivered. In the first method, the number of units of service authorized is based on the individual's utilization history. In the second method, authorization does not consider the individual's utilization history.
- F. When using half month units for residential services, the ISP should start on the first day of a month and end on the last day of a month. If it does not, it is possible that a provider will not be able to bill for a full month of service.
- G. The rounding rules in the standard service definitions must be considered during rate setting. Also, the county's contract with the provider defines a "day" of service.

#### **V. Tools for Rate Setting**

##### **A. Variance Analysis**

Variance analysis is the calculation and explanation of variances that result from a comparison of actual results with budgeted expectations. Variances that represent a significant difference between actual and budget justify investigation to determine the cause of the variance. Understanding the cause is essential to avoiding unfavorable variances in the future and capitalizing on improvements that caused favorable variances.

##### **B. Breakeven Analysis**

The breakeven point is the point at which income matches expenditures. The breakeven point can apply to a service or to the provider's entire operation. However, it is often preferred to calculate breakeven for individual services so it can be determined which services to continue or eliminate.

Once all costs are recovered, the provider can begin to generate retained revenue.

Breakeven analysis is a management tool that aids in planning, decision-making, and expense control. Examples of the use of breakeven analysis are:

1. Setting rates
2. Deciding whether to buy or lease
3. Determining strategic options for the provider (whether to expand into new services or counties)
4. Targeting optimal variable/fixed cost combinations

Breakeven analysis depends on the following variables:

1. Fixed costs for a service
2. Variable costs for a service
3. Rate for the service
4. Projected number of units of service to be delivered

A limitation of breakeven analysis is that it is a supply side analysis. It does not tell you anything about whether you can actually sell the service at that price.

## **VI. Audits**

Providers should prepare schedules as part of their audit, indicating the number of units provided, and the revenues derived from the provision of these units and the associated expenses of providing these units of service.

An agreed upon procedure engagement can be used as an alternative to audit for obtaining this information.