

Department of Health and Human Services

**OFFICE OF  
INSPECTOR GENERAL**

**REVIEW OF  
VENDOR REBATES  
PAID TO HOSPITALS**

**KAISER FOUNDATION  
HOSPITALS AND  
HEALTH PLANS, INC.  
OAKLAND, CALIFORNIA**



Daniel R. Levinson  
Inspector General

JUNE 2007  
A-05-07-00051

# ***Office of Inspector General***

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The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed, as well as other conclusions and recommendations in this report, represent the findings and opinions of the HHS/OIG/OAS. Authorized officials of the HHS divisions will make final determination on these matters.



**DEPARTMENT OF HEALTH AND HUMAN SERVICES**  
**OFFICE OF AUDIT SERVICES**  
**233 NORTH MICHIGAN AVENUE**  
**CHICAGO, ILLINOIS 60601**

**REGION V**  
**OFFICE OF**  
**INSPECTOR GENERAL**

June 4, 2007

Report Number: A-05-07-00051

Mr. Daniel Garcia  
Senior Vice President and Chief Compliance Officer  
Kaiser Foundation Hospitals and Health Plans, Inc.  
One Kaiser Plaza, 12<sup>th</sup> Floor  
Oakland, California 94612

Dear Mr. Garcia:

This final report provides the results of our audit of a vendor rebate in the amount of \$35,438 that a drug manufacturer paid to Kaiser Foundation Hospitals and Health Plans, Inc. of Oakland, California. We identified this rebate through a national statistical sample of rebates.

## **BACKGROUND**

### **Kaiser Foundation Hospitals and Health Plans, Inc.**

Kaiser Foundation Hospitals and Health Plans, Inc. (the provider) is one of three entities comprising Kaiser Permanente, the largest nonprofit managed health care organization in the United States. Kaiser Permanente is headquartered in Oakland, California, and serves health care needs in nine states and the District of Columbia.

### **Vendor Rebates**

A vendor rebate is a retroactive discount, allowance, or refund given to a health care provider after the full list price has been paid for a product or a service. Rebates are usually paid quarterly or annually and are usually dependent on achieving a specific purchasing volume. A rebate is paid directly to a provider (e.g., a hospital) or to a nonprovider (e.g., a group purchasing organization or distributor).

Federal regulations (42 CFR § 413.98) state that rebates are reductions in the cost of goods or services purchased and are not income. The Centers for Medicare & Medicaid Services (CMS) "Provider Reimbursement Manual" (part 1, chapter 8) requires hospitals and other health care providers to report all discounts on their Medicare cost reports.

### **Medicare Cost Reports**

Some types of Medicare-certified providers, such as hospitals, skilled nursing facilities, and home health agencies, must submit an annual Medicare cost report to a fiscal intermediary. The cost report contains provider information, including facility characteristics, utilization data, costs

and charges by cost center (in total and for Medicare), Medicare settlement data, and financial statement data. A cost center is generally an organizational unit having a common functional purpose for which direct and indirect costs are accumulated, allocated, and apportioned. Providers must reduce previously reported Medicare costs when they receive rebates.

## **OBJECTIVE, SCOPE, AND METHODOLOGY**

### **Objective**

Our objective was to determine whether the provider reduced costs reported on its fiscal year 2003 Medicare cost report by the \$35,438 vendor rebate it received.

### **Scope**

As part of a national statistical sample of rebates that a single drug vendor sent directly to providers, we selected a \$35,438 rebate (part of a \$70,875 check) that the provider received during calendar year 2003. We limited our review to identifying the rebate amount and determining whether the provider credited the amount in its accounting records and on its Medicare cost report. We did not perform a detailed review of the provider's internal controls.

We performed our fieldwork from October through November 2005 at the drug vendor's offices in Deerfield, Illinois. We requested and received information from the provider through phone contacts, mail, and electronic mail.

### **Methodology**

To accomplish our objective, we:

- reviewed Federal regulations and CMS guidance related to rebates,
- obtained a statistical sample of rebates paid by the vendor to identify providers that received the rebates,
- requested documentation from the provider regarding the reporting of the rebate,
- determined whether the provider credited the sampled rebate amount on its Medicare cost report, and
- quantified the dollar amount of any rebates not reported and used to reduce previously reported costs.

We conducted our audit in accordance with generally accepted government auditing standards.

## **FINDING AND RECOMMENDATIONS**

The provider did not reduce costs reported on its fiscal year 2003 Medicare cost report by the \$35,438 rebate, contrary to Federal regulations and CMS guidance. The provider recorded the rebate to non-cost reporting accounts. Rather than recording the rebate to inpatient pharmacy accounts, the provider recorded the rebate to outpatient pharmacy accounts that are not included as credits on its Medicare cost report. Providers must offset costs by rebates to ensure that they report the actual cost of services provided.

We recommend that the provider:

- revise and resubmit its 2003 Medicare cost report, if not already settled, to properly reflect the \$35,438 rebate as a credit reducing its health care costs; and
- consider performing a self-assessment of its internal controls to ensure that future vendor rebates are properly credited on its Medicare cost reports.

## **PROVIDER COMMENTS**

In its comments on the draft report, the provider agreed with our recommendations. The provider stated that in the future it will (1) revise all Medicare cost reports that have not been settled to include pharmacy rebates, and (2) continue to refine the methodology used to allocate pharmacy rebates to the Kaiser Permanente entities in 2007 and in subsequent cost reporting years. The provider's written comments are included as the Appendix.

\* \* \* \* \*

A copy of this report will be forwarded to the action official noted on the next page for review and any action deemed necessary. The HHS action official will make final determination as to actions taken on all matters reported. We request that you respond to the HHS action official within 30 days. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

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If you have any questions or comments about this report, please contact Jaime Saucedo at (312) 353-8693. Please refer to report number A-05-07-00051.

Sincerely,

A handwritten signature in black ink, appearing to read "Marc Gustafson", with a stylized flourish at the end.

Marc Gustafson  
Regional Inspector General  
for Audit Services

**Direct Reply to HHS Action Official:**

Mr. Jeff Flick  
Regional Administrator  
Centers for Medicare & Medicaid Services  
90 7<sup>th</sup> Street, Suite 5-300 (5W)  
San Francisco, California 94103

# **APPENDIX**





Kaiser Foundation Health Plan, Inc.  
Kaiser Foundation Hospitals

Daniel P. Garcia  
Senior Vice President  
Chief Compliance Officer

April 18, 2007

Marc Gustafson,  
Regional Inspector General for Audit Services  
Department of Health and Human Services  
Office of Inspector General  
Office of Audit Services  
233 North Michigan Avenue  
Chicago, IL 60601

Re: Report Number A-05-07-00051  
April 4, 2007 Report Re: Review of Vendor Rebates Paid to  
Hospitals, Kaiser Foundation Hospitals Oakland, California

Dear Mr. Gustafson:

This letter constitutes Kaiser Foundation Hospitals' (KFH) response to your office's April 4, 2007, report entitled "Office of Inspector General's Review of Vendor Rebates Paid to Hospitals, Kaiser Foundation Hospitals, Oakland, California." In the report, you asked that KFH do two things:

- Revise and resubmit its 2003 Medicare cost report, if not already settled, to properly reflect the \$35,438 rebate as a credit reducing its health care costs; and
- Consider performing a self-assessment of its internal controls to ensure that future vendor rebates are properly credited on our Medicare cost reports.

The following paragraphs summarize our responses to your requests.

### **Kaiser Foundation Hospitals' Responses**

#### **A. Revise and resubmit 2003 Medicare cost reports if not already settled.**

As you are likely aware, Medicare hospital reimbursement is no longer based on reasonable cost reimbursement and instead is based on a prospective payment system. Therefore, expenses incurred by hospitals and included on the hospital cost report do not generally directly or significantly impact hospital reimbursement. Therefore, the accounting for rebates on hospital cost reports may not significantly impact Medicare hospital reimbursement, or may not impact reimbursement at all. There may be some impact on the Medi-Cal (California Medicaid) hospital reimbursement, since this reimbursement is still based to some extent on a reasonable cost methodology. In any case, KFH will revise all Medicare and Medi-Cal hospital cost reports that have not been settled to include

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Marc Gustafson

April 17, 2007

Page 2

pharmacy rebates. The methodology for these entries is discussed below. For 2003, all but two cost reports have been settled. Most 2004 cost reports remain open and will be revised accordingly.

**B. Future rebates are properly credited to hospital cost reports.**

For the 2005 and 2006 hospital cost reports in each region, Kaiser Permanente (KP) allocated the total regional drug rebates received from the drug manufacturers to the KP entities based on drug expenses incurred by each KP entity as the allocation statistic. KP entities included hospitals, clinics, and health plans. Allocated rebates were then used to reduce cost report expenses accordingly. For regions with multiple hospitals, regional hospital allocation was further allocated to individual hospitals based on hospital drug expenses. We will continue to refine the methodology used to allocate pharmacy rebates to the KP entities in 2007 and later cost reporting years.

Thank you for allowing us the opportunity to respond to report findings. I hope the information above satisfactorily addresses your needs. Please feel free to contact me with any comments or questions. I may be reached at (510) 271-5781.

Very Truly Yours,

A handwritten signature in cursive script that reads "Daniel P. Garcia".

Daniel Garcia  
Senior Vice President and Chief Compliance Officer  
Kaiser Foundation Hospitals and Health Plans, Inc.