

Institutional Pharmacy Dispensing Cost Study

Long Term Care Pharmacy Alliance

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*Prepared by
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ACCOUNTING SERVICES REPORT ***Long Term Care Pharmacy Alliance***

DISPENSING COST STUDY BACKGROUND

Since 1983, Myers and Stauffer LC ("M&S") has performed various studies of pharmacy dispensing costs on behalf of 17 Medicaid state agencies. Key findings in their recent studies were that:

1. Pharmacies that dispense I.V. medications, as a significant portion of their business, can have dispensing costs far in excess of those found in a traditional pharmacy; and
2. There is no association between dispensing cost and unit dose delivery systems.

In these studies, pharmacies that dispense I.V. medications were often excluded when M&S developed their findings and conclusions, and the pharmacies included in the M&S studies provided minimal unit dose services.

As a result, members of the Long Term Care Pharmacy Alliance ("LTCPA" or "Alliance") attempted to identify their institutional pharmacy dispensing costs using a similar methodology to what M&S did in their studies. LTCPA hired BDO Seidman, LLP ("BDO") to perform certain accounting services relative to the financial information reported by the respective pharmacies and to consolidate the financial information in a summary report. The pharmacy companies participating included Kindred Pharmacy Services, NCS Healthcare, NeighborCare, Omnicare and PharMerica.

ACCOUNTING SERVICES OVERVIEW

The accounting services performed, summarized here, and more fully detailed elsewhere in this report, included:

- Preparing a consolidated pharmacy dispensing cost template for the three months ended 9/30/01, utilizing all dispensing costs incurred in the normal course of business;
- Preparing a consolidated pharmacy dispensing cost template for the three months ended 9/30/01, excluding certain dispensing costs that M&S did not recognize in their studies;
- Reviewing workpapers which crosswalk the figures reported on each pharmacy company's cost template to their trial balance for the quarter ended 9/30/01;
- Reviewing the workpapers supporting cost allocations to prescription drug services;
- Where possible, cross-walking the trial balance for the quarter ended 9/30/01 to each company's regulatory filings such as Securities and Exchange Commission (SEC) reporting; and

- Comparing template revenues and expenses to prior quarterly data for consistency.

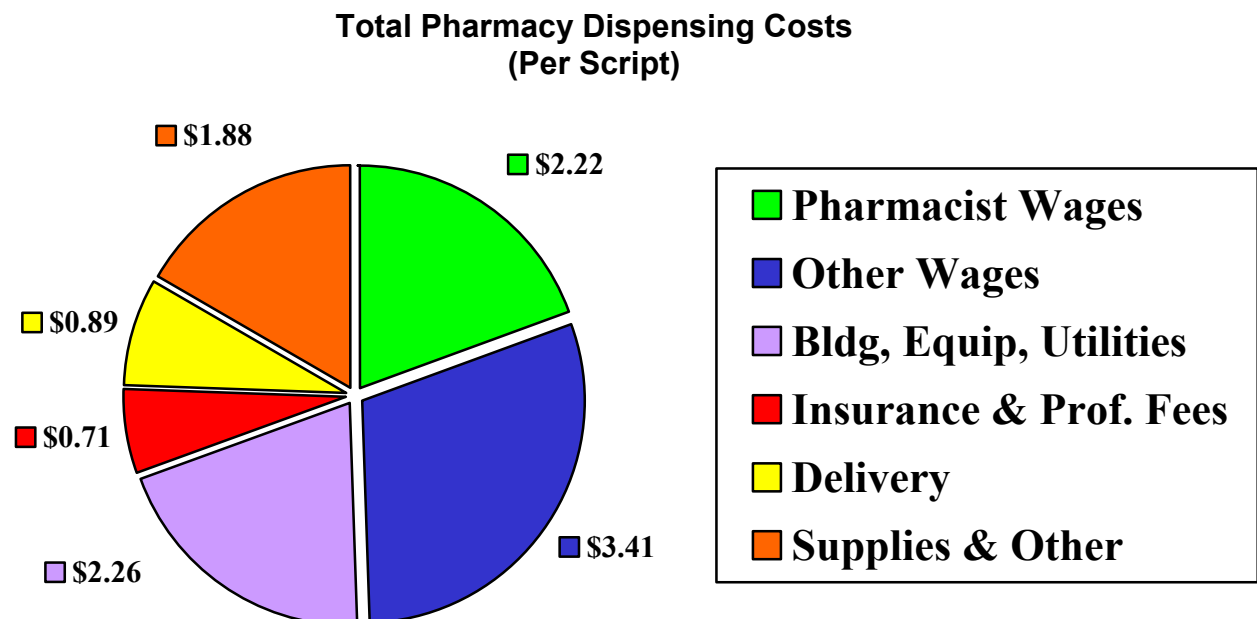
DESCRIPTION OF SERVICES PERFORMED

➤ **Prepared Two Consolidated Pharmacy Dispensing Cost Templates**

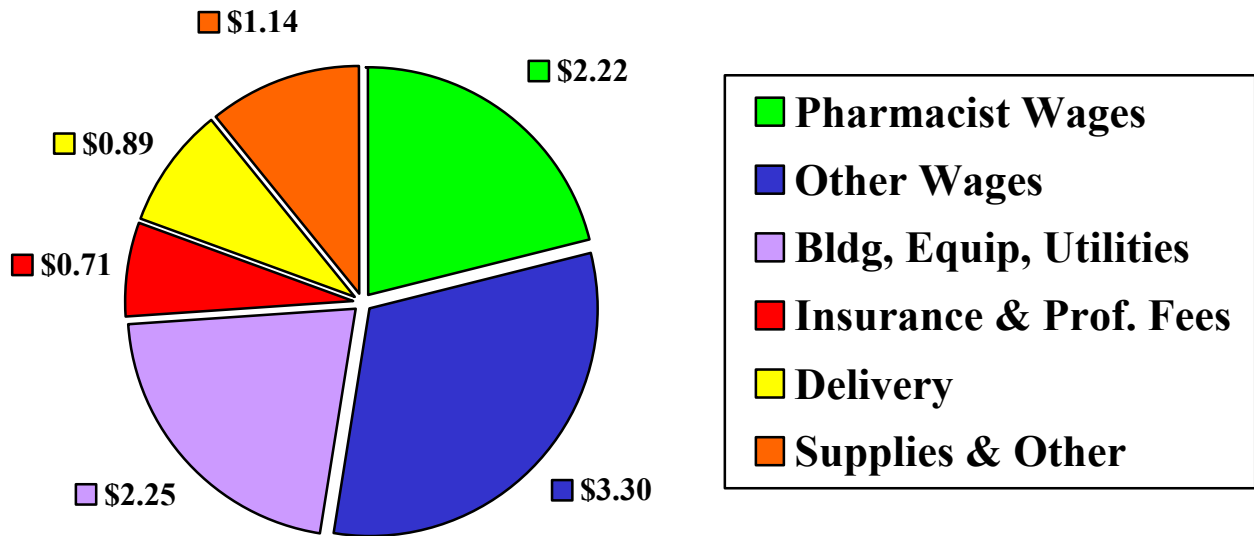
BDO prepared two summary "Pharmacy Dispensing" cost templates. The first cost template consolidated all dispensing costs incurred in the normal course of business for the five companies. From this, we calculated a dispensing cost of \$11.37 per prescription, by dividing total dispensing costs for the five companies by the total number of prescriptions. The calculated costs of dispensing included no return on equity investment, nor any profit margin. The summary template is included at the end of this report as Appendix A.

The second cost template consolidated dispensing costs for the five companies, but removed certain costs that M&S did not recognize in their studies. These costs included advertising, public relations, business development, bad debts, contributions and income taxes. These are costs that are typically not recognized in cost-based reimbursement systems. However, the dispensing fee as we understand it, is not a cost-based fee, but a price to compensate for all legitimate cost of operations. Nevertheless, for comparative purposes, we made similar disallowances in the second cost template. From this, we calculated a dispensing cost of \$10.51 per prescription. The summary template is included at the end of this report as Appendix B.

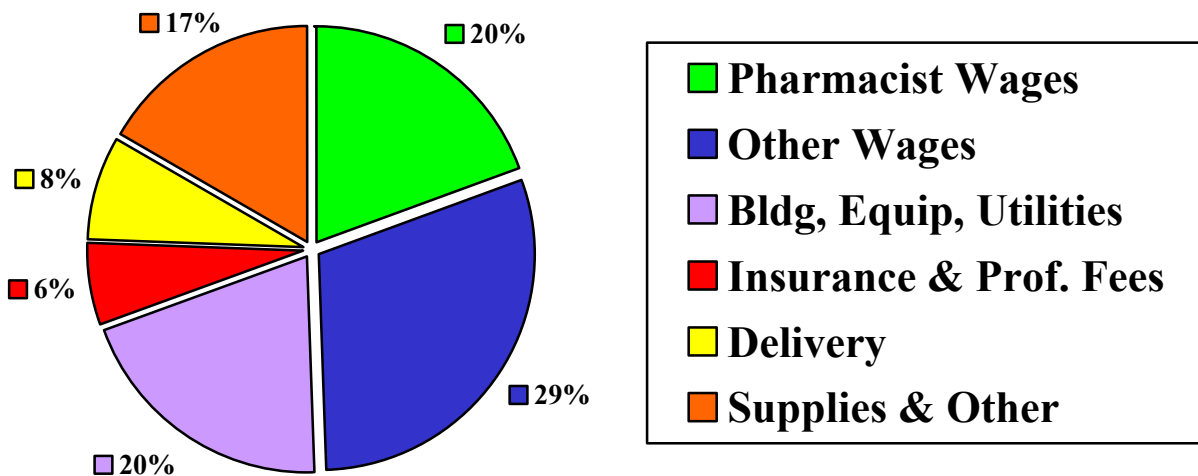
The chart below and the charts on the following two pages illustrate the consolidated dispensing costs per script by cost component and as a percentage of total cost.



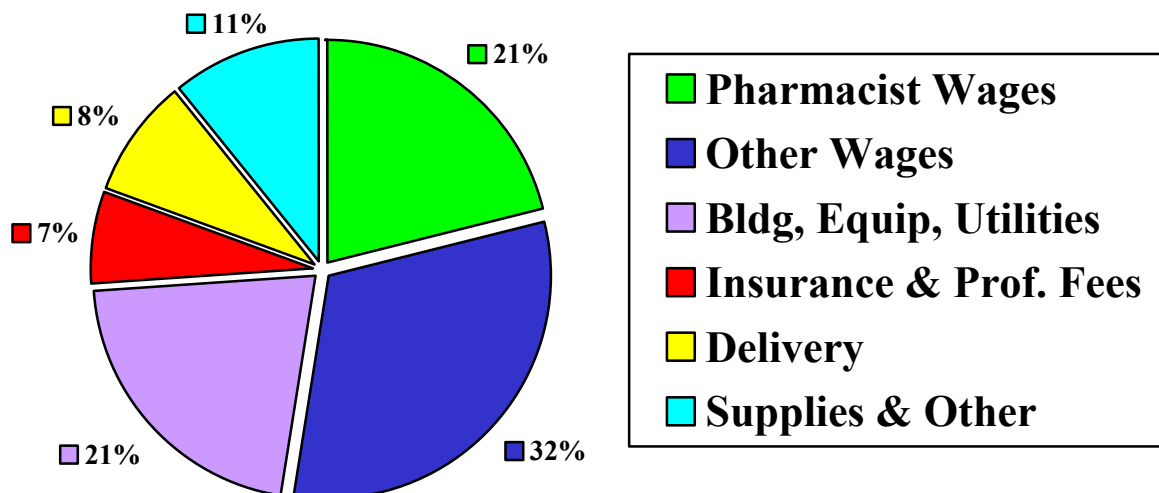
**Pharmacy Dispensing Costs
Utilizing M&S "Allowable Cost" Approach
(Per Script)**



**Total Pharmacy Dispensing Costs
(As a Percent of Total)**



**Pharmacy Dispensing Costs
Utilizing M&S "Allowable Cost" Approach
(As a Percent of Total)**



➤ **Reviewed Workpapers Cross-walking the Trial Balances to the Corresponding Templates.**

For each company, BDO reviewed workpapers and the trial balance for the quarter ended 9/30/01¹, which supported the financial information on the template. Net revenue and prescription drug revenue reported on the trial balances reconciled with the amounts reported on the templates. Prescription counts on the template agreed with supporting workpapers or prescription counts generated from the pharmacies' computer systems. Total floor space and prescription floor space were also reconciled with company supporting documentation. Two companies were unable to provide actual floor space measurements and therefore utilized estimates in their spatial allocations.

Trial balance costs for the quarter ended 9/30/01 were cross-walked to the figures on the template. In doing so, we:

1. Reviewed the mapping of trial balance accounts to those on the template for reasonableness;
2. Insured that the dollar amounts by line item or grouping on the trial balance agreed with that reported on the appropriate line of the template, noting only a few immaterial variances;
3. Reconciled total expense on the dispensing template with that reported on the trial balance;

¹ One company was unable to provide actual quarterly data and instead provided two months of data that was prorated to represent a full quarter.

4. Reviewed company-prepared reconciliations reflecting adjustments to expenses between the trial balance and the dispensing cost template. Adjustments were occasionally made to exclude one-time expenses that, if included, would skew the quarterly figures. For instance, for one company, a material sales tax adjustment recorded in the third quarter was excluded from the template;
5. Obtained assurances from management that non-pharmacy business line expenses were excluded from the dispensing cost template;
6. Examined workpapers and/or general ledger activity reports used to itemize expense items on the dispensing cost template. For example, payroll reports were used by several companies to delineate pharmacy wages from other indirect wages; and
7. Reviewed the general ledger detail for tax and insurance accounts and reconciled the amounts to the dispensing cost template.

➤ **Reviewed Supporting Cost Allocation Workpapers**

BDO reviewed the workpapers supporting expense allocations on the trial balances and corresponding templates. In doing so, we:

1. Reviewed trial balance account descriptions that were likely to require allocations;
2. Contacted company management to clarify general ledger account allocations and request supporting documentation and methodology;
3. Insured that workpapers were prepared for all allocations and reviewed them for reasonableness; and
4. Reviewed workpapers supporting the allocation of corporate overhead expenses.²

➤ **Agreed the Trial Balances for the Quarter Ended 9/30/01 to SEC Filings**

For two companies, BDO reconciled their 9/30/01 trial balances with their September 30, 2001 quarterly SEC filings relative to pharmacy revenues and expenses. We were unable to do so for the other two publicly held companies³ due to the complexities in their reporting structure requiring numerous consolidations that ultimately roll up to their SEC reports. In such cases, a representation letter was provided indicating that the financial information reported on their trial balances was the same as that reported in the SEC filings.

➤ **Compared Template Revenues and Expenses to Prior Quarterly Data**

² One company did not include corporate overhead on the cost template. For another, the corporate allocated expenses were budgeted rather than actual.

³ One company is closely held and therefore no reconciliation was needed.

BDO compared revenues and expenses on the trial balances for consistency with prior quarters. The first and second quarter figures were compared to the third quarter of 2001. The comparisons revealed no material discrepancies by company from quarter to quarter.

FINDINGS AND CONCLUSIONS

The pharmacy revenues, costs, and statistical information, as reflected on the cost templates reconciled, with minor variances, to the trial balances and supporting workpapers for the quarter ended 9/30/01 for the five companies. Workpapers provided supported all allocations made between prescription and non-prescription services. The financial information and statistics provided were consistent with prior quarters and with what was reported in SEC filings based upon reconciliations prepared by the companies or written assurances provided by them.

Institutional pharmacies do have higher dispensing costs than retail pharmacies. Pharmacies with a considerable unit dose volume will inherently have higher costs simply due to the increased costs of packaging. Delivery costs are also significantly higher for institutional pharmacies, especially those that provide services to institutional provider-clients in outlying areas. M&S has already acknowledged the significantly higher cost of dispensing for I.V. services, which represents a much higher volume of business in institutional pharmacies. These pharmacies also have a greater percentage of their business funded by the Medicaid and Medicare programs resulting in higher receivables, greater working capital requirements, and a higher percentage of bad debts. Finally, institutional pharmacies provide considerable on-site support and consultation to their institutional provider-clients, which happens less frequently in the retail setting.

List of Appendices

- Appendix A - Consolidated Template and Dispensing Cost Calculation:
All Dispensing Costs**

- Appendix B - Consolidated Template and Dispensing Cost Calculation:
M&S "Allowable Cost" Approach**