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Health care industry developments - 2000/01; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Health Care Industry Developments—2000/01

Complement to AICPA Audit and Accounting Guide *Health Care Organizations*

American Institute of Certified Public Accountants

AICPA

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of health care organizations with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

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In This Year's Alert...

Economic and Industry Developments

- *What are the industry and economic conditions facing health care organizations in the current year? Page 7*

Regulatory Issues and Developments

- *What are some of the recent regulatory developments that auditors of health care organizations should be aware of? Page 17*
- *What are some of the recent National Association of Insurance Commissioners developments affecting managed care organizations? Page 26*
- *What are some of the recent Internal Revenue Service developments that auditors of health care organizations should know about? Page 27*

New Auditing and Attestation Pronouncements

- *What are the new auditing and attestation pronouncements that auditors of health care organizations should be aware of? Page 29*

Audit Issues and Developments

- *What effect do the allegations of violations of laws and regulations in the health care industry have on this year's audits? Page 45*
- *What are some of the issues that auditors should consider when auditing health care organizations affected by the new Medicare prospective payment system regulations for outpatient services and home health agencies? Page 49*
- *What are some of the conforming changes made to the May 2000 edition of the AICPA Audit and Accounting Guide* Health Care Organizations? *Page 52*

Accounting Issues and Developments

- *What are the requirements of FASB Statement No. 136,* Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others? *Page 58*
- *What are some of the recent developments affecting the accounting for derivatives and hedging activities? Page 64*

- *What are the requirements of the new FASB Statement No. 140,* Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*? Page 66*

- *What are some of the recent SEC developments that may affect health care organizations subject to SEC regulations? Page 69*

On the Horizon

- *What are some of the exposure drafts that have been issued by the FASB for comment? Page 77*

- *What exposure draft has been issued by the ASB for comment? Page 80*

Resource Central

- *What other AICPA publications, services, and products can be of value to auditors of health care organizations? Page 80*

Table of Contents

Health Care Industry Developments—2000/01 7

Economic and Industry Developments 7

Technological Developments 10

Merger and Acquisition Activity 12

Risks and Uncertainties 13

Fraud Risk Factors 14

Going-Concern Issues 15

Regulatory Issues and Developments 17

The Health Insurance Portability and Accountability Act of 1996 17

Other Governmental Regulations and Investigations Relating to Fraud and Abuse Violations 21

Prospective Payment Systems for Outpatient Services and Home Health Care Agencies 23

Corporate Compliance 24

National Association of Insurance Commissioners Developments 26

Internal Revenue Service Developments 27

New Auditing and Attestation Pronouncements 29

SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables* 30

Auditing Standards 35

Auditing Interpretations 42

New Attestation Standard 43

Audit Issues and Developments 45

Fraud and Abuse in the Health Care Industry 45

Implementing New Prospective Payment Systems 49

Revision of SOP 98-3 52

2000 AICPA Health Care Organizations Audit and Accounting Guide 52

Impact of New Accounting Pronouncements 54
PITF Practice Alerts 55
Official Statements Offering Securities for Sale and Municipal Securities Disclosures 56

Accounting Issues and Developments 58
Transfers of Assets 58
Derivatives and Hedging Activities 64
Transfers and Servicing of Financial Assets and Extinguishments of Liabilities 66
EITF Topic D-89, *Accounting for Costs of Future Medicare Compliance Audits* 67
Other New FASB Pronouncements 68
SEC Issues and Developments 69
National Federation of Municipal Analysts Recommended Best Practices 75
New GASB Standards 76

On the Horizon 77
FASB Exposure Drafts 77
ASB Exposure Drafts 80

Resource Central 80
Order Department (Member Satisfaction) 80
Health Care Organizations Checklists 81
National Health Care Industry Conference 81
Continuing Professional Education Courses 81
Assurance Services Alerts 82
Accounting and Auditing Technical Hotline 83
Ethics Hotline 83
Technical Practice Aids 83

References for Additional Guidance 83

APPENDIX A—THE INTERNET—AN AUDITOR'S RESEARCH TOOL 85

APPENDIX B—COMPLIANCE GUIDELINES 87

APPENDIX C—AICPA INDUSTRY EXPERT PANEL 92

Health Care Industry Developments—2000/01

Economic and Industry Developments

What are the industry and economic conditions facing health care organizations in the current year?

The positive growth in the U.S. economy of recent years continued through the end of 1999 and the third quarter of 2000, fueled in part by increased workforce productivity and consumer spending. In February 2000, the current period of economic expansion became the longest in history.

Among the economic statistics and other developments through the first three quarters of 2000 are the following:

- The U.S. jobless rate remained under 4.5 percent, reaching a thirty-year low of 3.9 percent in April and September 2000.
- The much-anticipated Year 2000 Issue, with its potential for negative economic implications, has so far passed without any major impact.
- The equities markets continued to display periods of volatility. Both the Dow Jones Industrial Average (DJIA) and the National Association of Securities Dealers Automated Quotation (NASDAQ) composite ended 1999 at record highs, nearly 11,500 for the DJIA and over 4,000 for the NASDAQ. By March 2000, the NASDAQ reached a new milestone, closing over 5,000 for the first time. After reaching these milestones, however, both the DJIA and NASDAQ experienced steep declines, as well as periodic gains back upward toward these earlier milestones.

Keep in mind that this section of this Audit Risk Alert notes only a few of the recent economic statistics and developments. Also, there are regional differences that may need to be taken into consideration. For example, unemployment statistics might show a variation when comparing one region in the United States with another. Also, not all segments of the health care industry may benefit equally during a period of economic prosperity.

The auditor should review the guidance in Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), regarding the specific procedures that should be considered in planning an audit in accordance with generally accepted auditing standards (GAAS). The auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics, and consider matters affecting the health care industry overall, as well as the industry segment in which the entity operates, including, among other matters, economic conditions, as they relate to his or her audit.

Operating margins for hospitals and other health care providers, on average, deteriorated during 1999, with the initial impact of the Balanced Budget Act of 1997 (BBA) often cited as a reason for the decline in operating margins. While the 1999 Balanced Budget Refinement Act includes provisions to provide some marginal relief for certain providers of health care services, the next few years may continue to be a financial and operating challenge for health care industry executives and boards of directors. Meanwhile, a number of managed care organizations experienced financial difficulties, and health care costs and health insurance premiums continued to rise. Also, a number of nursing homes in the United States are either owned or operated by companies that are in bankruptcy.

Some health care organizations that may have just spent significant resources addressing the Year 2000 Issue may now be experiencing additional financial pressures as they focus on addressing and implementing the requirements of the new prospective payment systems (PPS) rules from Medicare for outpatient services and home health agencies that went into effect in 2000, along with the requirements of the Administrative Simplification provisions of the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Managed care organizations additionally are likely addressing the adoption of the National Association of Insurance Commissioners (NAIC) codification of statutory accounting principles. See the related discussions, "The Health Insurance Portability and Accountability Act of 1996," "Prospective Payment Systems for Outpatient Services and Home Health Care Agencies," and "Codification of Statutory Accounting Principles" in the "Regulatory Issues and Developments" section of this Audit Risk Alert, and "Implementing New Prospective Payment Systems" in the "Audit Issues and Developments" section of this Audit Risk Alert.

Many health care organizations continue to address the needs of consumers of health care services who are without insurance coverage. While the unemployment rate has remained low, not all of the jobs created have provided workers with health insurance benefits. A large segment of the population in the United States, estimated at approximately 44 million individuals, working and nonworking, are without health insurance.

As the baby boomer segment of the U.S. population continues to age and the life expectancy of the U.S. population has increased, so has the number of health care consumers enrolled in the federal Medicare Program. The federal Medicare Program, which is administered by the Health Care Finance Administration (HCFA), insures approximately 40 million beneficiaries. The HCFA established the Medicare+Choice Program as an option to allow Medicare Program beneficiaries to participate in health maintenance organizations (HMOs). Currently, while most Medicare Program beneficiaries continue to keep the traditional fee-for-service Medicare insurance, about 16 percent of Medicare Program participants have elected to join Medicare HMOs. While Medicare HMOs must provide the same benefits as traditional fee-for-service Medicare, Medicare HMOs also can provide additional benefits, such as coverage of pharmaceutical costs. During 2000, a number of Medicare Program participants who elected to enroll in Medicare HMOs were affected by the decision of some of these managed care companies to drop their coverage of Medicare plans in certain areas of the United States. This decision has been attributed by a number of Medicare HMOs to the increasing gap between the amounts paid out and the reduced federal payments received as a result of the BBA. Other Medicare HMOs also have reduced the benefits they provide to certain participants.

In 2000, as in prior years, federal and state governments have been aggressive in pursuing health care cost savings and developing strategies to eliminate fraud, waste, and abuse in governmental health care programs. For additional information on government regulation and programs established to identify and eliminate fraud and abuse in health care programs, see the related discussions, "The Health Insurance Portability and Accountability Act of 1996," and "Other Governmental Regulations and Investigations Relating to Fraud and Abuse Violations," in the "Regulatory Issues and Developments" section and "Fraud and Abuse in the Health Care Industry" in the "Audit Issues and Developments" section of this Audit Risk Alert.

Overall, enrollment by health care consumers in managed care plans continued to be strong during 2000. In an effort to maintain and grow market share in recent years, managed care plans did not increase premiums sufficiently to cover significant cost increases. As a result, many managed care plans found themselves with significant operating losses. Some have changed their focus from increased market share to increased profits. Premium increases that had moderated in recent years began to rise in 1999 and continued to rise in 2000. Some health care consumers participating in managed care plans have sought and gained changes to rules that limit accessibility to their choice of doctor. Some managed care plans, responding to demands of the consumers and providers of health care, have changed established policies to enable doctors to make final decisions about the health care procedures that will be provided.

Technological Developments

New technological developments continue to expand the available options in health care products and services, in some cases resulting in higher-costing alternatives to existing products and services. Meanwhile, some health care payers are promoting telemedicine as a cost-saving method of medical delivery. Telemedicine uses electronic communications technology to provide patient care and diagnosis over distances. Federal and state legislators, as well as health care payers, are addressing issues related to the use of telemedicine as an alternative to traditional delivery of health care.

Health care organizations continue to focus on information technology developments to meet the need for greater efficiency and the demands of consumers for up-to-date medical services, as well as to implement the improvements needed to facilitate electronic commerce in areas such as claims processing. Among the top priorities of health care organizations is the computerization of patient records.

As a growing number of consumers of health care services are using the Internet to obtain information about available health care services and products, so are many health care organizations using the Internet in a number of ways. Web sites have been used, for example, to communicate medical information to patients and enable the public to view Form 990 filings by exempt health care organizations, subjecting the information in Form 990 filings to greater public scrutiny. In addition to using the Internet for marketing and communication, some health care organizations are using the Internet to store patient records and process claims. In such circumstances, auditors may need to consider relevant provisions of the professional literature, including the provisions of—

- SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), as amended. SAS No. 31, as amended, provides guidance to auditors who have been engaged to audit the financial statements of an entity that transmits, processes, maintains, or accesses significant information electronically.
- SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). Note that control risk may be changed (as discussed in SAS No. 55) by such factors as new or revamped information systems, new technologies, and other circumstances.

Consumers of health care services have expressed concerns over the privacy of health information. The federal government is addressing the issue of privacy concerns associated with individually identifiable health information that is transmitted or maintained in electronic form. See the related discussion, "The Health Insurance Portability and Accountability Act of 1996," in the "Regulatory Issues and Developments" section of this Audit Risk Alert.

Merger and Acquisition Activity

During recent years, merger and acquisition activity was a dominant factor in many sectors of the health care industry. Consolidation of health care organizations continued in 2000 as health care organizations found themselves trying to achieve the dual objectives of meeting consumer demand for quality health care and cutting health care costs. However, the level of merger and acquisition activity in certain sectors of the health care industry decreased during 2000, when compared with the level of merger and acquisition activity of recent years. The health care industry has also seen some of the merger and acquisition transactions of recent years break apart, bringing the possibility for significant impact on the affected health care organizations.

Auditing and accounting issues that can arise from a consolidation, or from the unwinding of a merger, can be numerous and varied. Auditors should consider the particular circumstances of the client to identify the specific accounting and auditing issues, and then develop the appropriate audit strategy. For example, auditors should consider whether an acquisition has been appropriately accounted for by the client. Goodwill arising from a purchase transaction, for example, may be an especially judgmental area and is therefore likely to require close scrutiny.[1] The issue of goodwill as it relates to entities reporting to the Securities and Exchange Commission (SEC) is discussed in SEC Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*. See the related discussion "SEC Issues and Developments" in the "Accounting Issues and Developments" section of this Audit Risk Alert. Also, see the newly introduced Audit Risk

1. The Financial Accounting Standards Board (FASB) issued an exposure draft of a proposed Statement of Financial Accounting Standards in September 1999, *Business Combinations and Intangible Assets*, which among its provisions discusses accounting for goodwill. Auditors should be alert for the issuance of a final statement or other developments related to this FASB project. Further information related to FASB projects can be obtained from the FASB Web site at www.fasb.org.

Alert—*SEC Alert.* The *SEC Alert* provides valuable insights into SEC staff perspectives on important accounting and auditing matters, along with updates on recent SEC activities.

Also, with consolidation, there can be dramatic changes in the structure of an entity. In an effort to create greater cost efficiencies, departments are combined and duplicate functions are eliminated. At the same time, the entity continues to need skilled personnel with knowledge of the unique regulatory and accounting considerations for organizations in the health care industry. With an unwinding of a merger and acquisition, there is a potential for effects on many areas of the health care organization, such as on existing contracts, including managed care contracts, financing arrangements, and staffing.

Auditors should consider the impact of such changes on the health care organization's internal control when making the assessment of control risk. Auditors should obtain a sufficient understanding of internal control to plan the audit and determine the nature, timing, and extent of tests to be performed. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, outlines the auditor's responsibilities with regard to considering a client's internal control in planning and performing an audit.

Risks and Uncertainties

Auditors should consider the extent to which changes in the health care industry can result in any new risks or uncertainties that would require management to make appropriate disclosure in the financial statements in accordance with the requirements of Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 states that the volatile business and economic environment underscores a need for improved disclosure about the significant risks and uncertainties that face reporting entities. For additional discussions regarding consideration of the requirements of SOP 94-6, see "Fraud and Abuse in the Health Care Industry" in the "Audit Issues and Developments" section of this Audit Risk Alert and "SOP 00-1, *Auditing Health Care Revenues and Related Receivables*" in the "New Audit and Attestation Pronouncements" section of this Audit Risk Alert.

Fraud Risk Factors

Auditors should consider whether any current health care industry developments represent a fraud risk factor that should be considered in the assessment of the risk of material misstatement due to fraud under SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). SAS No. 82 provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. SAS No. 82 includes a list of examples of risk factors relating to misstatements arising from fraudulent financial reporting, including risk factors related to industry conditions. SAS No. 82 lists the following examples among the risk factors that can relate to misstatements arising from fraudulent financial reporting:

- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.
- High degree of competition or market saturation, accompanied by declining margins.
- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity—such as ultimate collectibility of receivables, timing of revenue recognition, realizability of financial instruments based on the highly subjective valuation of collateral or difficult-to-assess repayment sources, or significant deferral of costs.
- Adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported.

Help Desk—Further information on implementing SAS No. 82 is available in the AICPA publication, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883kk). This Practice Aid provides an in-depth understanding of SAS No. 82, supplemented by practice aids and examples including common fraud schemes and expanded audit procedures; sample engagement letters, representation letters, and workpaper documentation; and industry-specific fraud risk factors and guidance for several specialized industries, including health care organizations. See the "Resource Central" section of this Audit Risk Alert for information on ordering AICPA publications.

Going-Concern Issues

Auditors of health care organizations may identify information about certain conditions or events that, when considered in the aggregate, indicate that there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides examples of such conditions and events. The examples include—

- Negative trends (for example, recurring financial losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios).
- Other indications of possible financial difficulties (examples include the need to seek new sources or methods of financing or to dispose of substantial assets).
- Internal matters (examples include the need to significantly revise operations).
- External matters that have occurred (examples include legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate).

SAS No. 59, among other matters, provides guidance to the auditor in conducting an audit of financial statements in accordance with GAAS with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern. Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions to its operations, or similar actions.

Executive Summary—Economic and Industry Developments

- The positive growth in the U.S. economy in recent years continued through the end of 1999 and the third quarter of 2000.
- Operating margins for hospitals and other health care providers, on average, deteriorated during 1999, with the initial impact of the BBA often cited as a reason for the decline in operating margins.
- Some health care organizations that may have just spent significant resources addressing the Year 2000 Issue may now be experiencing additional financial pressures as they focus on addressing and implementing the requirements of the new PPS rules from Medicare for outpatient services and home health agencies that went into effect in 2000, along with the Administrative Simplification provisions of HIPAA. Managed care organizations additionally are likely dealing with the adoption of the NAIC codification of statutory accounting principles.
- In 2000, as in prior years, federal and state governments have been aggressive in pursuing health care cost savings and developing strategies to eliminate fraud, waste, and abuse in governmental health care programs.
- Health care organizations continue to focus on information technology developments to meet the need for greater efficiency and the demands of consumers for up-to-date medical services, as well as to implement the improvements needed to facilitate electronic commerce in areas such as claims processing.
- The level of merger and acquisition activity in certain sectors of the health care industry decreased in 2000 when compared with the level of merger and acquisition activity of recent years. The health care industry has also seen some of the merger and acquisition transactions of recent years break apart.

- Auditors should consider whether any current industry developments represent a fraud risk factor that should be considered in the assessment of the risk of material misstatement due to fraud under SAS No. 82, *Consideration of Fraud in a Financial Statement Audit.*
- Auditors of health care organizations may identify information about certain conditions or events that, when considered in the aggregate, indicate that there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

Regulatory Issues and Developments[2]

What are some of the recent regulatory developments that auditors of health care organizations should be aware of?

Federal and state governments continue to uncover instances of fraud, waste, and abuse in governmental health care programs. Continuing the trend of recent years, in 1999 the federal government won or negotiated more than $524 million in judgments, settlements, and administrative impositions in health care fraud cases and proceedings. Also in 1999, a National Health Care Fraud Task Force was launched, where the Department of Health and Human Services (HHS) Office of Inspector General (OIG), the HCFA, the Department of Justice, and state and local prosecutors work together to formulate strategies to combat health care fraud and abuse.

The Health Insurance Portability and Accountability Act of 1996

The Administrative Simplification provisions of HIPAA were enacted to improve the efficiency and effectiveness of the health care system by standardizing electronic data interchange while protecting the security and privacy of health care information, and reducing the costs and administrative burdens of health care.

2. The brief summaries provided in this section of the Audit Risk Alert are for informational purposes only. Readers should refer to the full text of the regulations and regulatory publications discussed in this section of the Audit Risk Alert. Auditors should also be alert for amendments or updates to the topics discussed in this section of the Audit Risk Alert and for other recent developments related to regulatory and Internal Revenue Service activities. Appendix A to this Audit Risk Alert provides a list of Internet resources, including some Web sites that can provide information on regulatory and tax issues that may affect health care organizations.

To address the Administrative Simplification provisions of HIPAA, HHS announced several proposed rules in 1998 in a series of Notices of Proposed Rulemaking. These were followed in 1999 with HHS issuing proposed standards to protect the privacy of individually identifiable health information. Then, in 2000, HHS issued a final rule under the Administrative Simplification provisions that adopted standards for eight electronic transactions, and code sets to be used in those transactions. A brief discussion of the proposed rule issued in 1999 and the final rule issued in 2000 follows.

- *Health care transactions.* HHS issued a final rule that establishes standard data content and formats for submitting electronic claims and other administrative health transactions. The standards were adopted for the following administrative and financial health transactions:
  1. Health claims or equivalent encounter information
  2. Eligibility for a health plan
  3. Referral certification and authorization
  4. Health care claim status
  5. Enrollment and disenrollment in a health plan
  6. Health care payment and remittance advice
  7. Health plan premium payments
  8. Coordination of benefits

The final rule contains the requirements concerning the use of these standards by private and government sector health plans, health care clearinghouses, and certain health care providers. Health plans, with the exception of small plans, health care clearinghouses, and health care providers that choose to transmit their transactions in electronic form, have to comply within twenty-six months from the publication date. The standards are published in the August 17, 2000, *Federal Register.*

- *Privacy protection.* HHS proposed standards for privacy of individually identifiable health information were published in the November 3, 1999, *Federal Register.* The proposed standards would—

- Apply to medical records created by hospitals, health plans, health care clearinghouses, and health care providers that are transmitted or maintained in an electronic form and the paper printouts created from these records.
- Apply to consumers whether they are privately insured, uninsured, or participants in public programs such as Medicare or Medicaid.
- Require each covered organization to establish clear procedures to protect a patient's privacy, designate an official to monitor that system, and notify its patients about privacy protection practices.
- Include new penalties for violations, including civil monetary penalties and substantial criminal penalties that apply to certain types of violations of the statute, done knowingly.

The proposed standards would apply to all health plans, all health care clearinghouses, and all health care providers that transmit health information in an electronic form in connection with a standard transaction, referred to in the proposed rules as "covered entities." HHS does not have authority to apply these standards to any entity that is not a covered entity. Attempting in part to fill this gap in legislative authority, the proposed standards would require covered entities to take specific steps to ensure that protected health information disclosed to business partners is protected. A business partner could include auditors, accountants, contractors, consultants, and others. Under the proposed standards, a business partner could have no more authority to use or disclose protected health information than the covered entity from which the business partner received the information. The business partner's use and disclosure of protected health information would be limited by the terms of the business partner's contractual agreement with the covered entity.

For health care organizations that are affected by the HIPAA Administrative Simplification regulations, compliance efforts may require a multi-year effort with the potential for significant resource outlays, including major changes to existing processing systems.

Noncompliance with Administrative Simplification regulations can subject affected health care organizations to monetary penalties.

HIPAA also provides for hundreds of millions of dollars designed to detect fraud and abuse in the delivery of health care. HIPAA established a Health Care Fraud and Abuse Control Program to help fund Medicare and Medicaid anti-fraud and abuse activities. HIPAA also authorized the establishment of the Medicare Integrity Program to ensure that Medicare pays only for covered services that are reasonable and medically necessary, and should not be paid by other insurers. Also among the developments during the past year is the creation of the Healthcare Integrity and Protection Data Bank (HIPDB), a national data bank that would receive and disclose certain final adverse actions against health care providers, suppliers, or practitioners.

HIPAA significantly revised and strengthened the OIG's existing civil money penalty authorities pertaining to violations under Medicare and state health care programs. The OIG issued final regulations, published in the April 26, 2000, *Federal Register*[3] that revised the OIG's civil money penalty authorities in conjunction with the new and revised provisions that were set forth in HIPAA and codified a number of technical corrections.

Executive Summary—The Health Insurance Portability and Accountability Act of 1996

- HHS issued a final rule in 2000 under the HIPAA Administrative Simplification provisions that establishes standard data content and formats for submitting electronic claims and other administrative health transactions.
- In 1999, HHS proposed privacy protection standards for individually identifiable health information.
- For health care organizations affected by the HIPAA Administrative Simplification regulations, compliance efforts may require a multiyear effort with the potential for significant resource outlays.
- The HIPDB was created to receive and disclose certain final adverse actions against health care providers, suppliers, or practitioners.

3. Correction amendments were published in the June 5, 2000, *Federal Register*.

Other Governmental Regulations and Investigations Relating to Fraud and Abuse Violations

Anti-Kickback Statute Safe Harbors

In November 1999, the OIG published eight new regulatory safe harbors to the federal anti-kickback statute. Violations of the federal anti-kickback law are punishable by up to five years in prison, criminal fines of up to $25,000, administrative civil money penalties of up to $50,000, and exclusion from participation in federal health care programs.

The eight new safe harbors, which protect certain arrangements from prosecution under the anti-kickback statute, address the following payment or business practices:

1. Investments in underserved areas
2. Practitioner recruitment in underserved areas
3. Obstetrical malpractice insurance subsidies for underserved areas
4. Sales of physician practices to hospitals in underserved areas
5. Investments in ambulatory surgical centers
6. Investments in group practices
7. Referral arrangements for specialty services
8. Cooperative hospital service organizations

In addition, the OIG clarified six of the eleven safe harbors published in 1991, and published an interim final rule establishing two additional safe harbors for shared-risk arrangements.

> **Help Desk**—Further information is available on the HHS/OIG Web site at www.dhhs.gov. The final rule and interim final rule were published in the November 19, 1999, *Federal Register.*

Patient Anti-Dumping Statute

In November 1999 the OIG issued a special advisory bulletin making clear that the federal patient anti-dumping law (Emergency Medical Treatment and Active Labor Act) requires that medical screening and stabilizing treatment be provided in an emergency, despite the terms of any managed care agreements among plans, hospitals, doctors, and enrollees. Under the 1986 patient anti-dumping law, all Medicare-participating hospitals with emergency rooms must provide all patients requesting emergency care with an appropriate medical screening to determine if the person has an emergency medical condition. If the person has an emergency medical condition the hospital must provide stabilizing care within its capabilities. Violators of the anti-dumping law face penalties including civil money penalties of up to $50,000 for each offense for large hospitals and doctors who negligently violate any requirements, and $25,000 per violation for hospitals with fewer than 100 beds.

Help Desk—Further information is available on the HHS/OIG Web site at www.dhhs.gov. The advisory bulletin was published in the November 10, 1999, *Federal Register.*

Other Regulatory Developments

The OIG issued a special advisory bulletin in 1999, *The Effect of Exclusion From Participation in Federal Health Care Programs*, stating that health care providers should determine whether potential and current employees and contractors have been excluded from federal health care program participation. Civil money penalties can be imposed by the OIG against excluded individuals and entities seeking reimbursement from federal health care programs and health care providers that employ or enter into contracts with excluded individuals to provide items or services to federal program beneficiaries.

See the related discussion "Fraud and Abuse in the Health Care Industry" in the "Audit Issues and Developments" section of this Audit Risk Alert for a discussion of audit considerations and the auditor's responsibilities with respect to detecting fraud and abuse during a financial statement audit.

Executive Summary—Other Governmental Regulations and Investigations Relating to Fraud and Abuse Violations

- The OIG published eight new regulatory safe harbors to the federal anti-kickback statute.
- In November 1999 the OIG issued a special advisory bulletin making clear that the federal patient anti-dumping law requires that medical screening and stabilizing treatment be provided in an emergency, despite the terms of any managed care agreements among plans, hospitals, doctors, and enrollees.
- The OIG issued a special advisory bulletin, *The Effect of Exclusion From Participation in Federal Health Care Programs.*

Prospective Payment Systems for Outpatient Services and Home Health Care Agencies

The BBA, as amended, authorized the HCFA to establish and implement a Medicare PPS for outpatient services. Final rules for the PPS for outpatient services were published in the April 7, 2000, *Federal Register.* Medicare claims received by the HCFA for outpatient services provided on or after August 1, 2000, are paid under new PPS rules, which use Ambulatory Payment Classification (APC) Groups to classify outpatient services. A payment rate is established for each APC. Payments for outpatient services by Medicare will be made at set amounts, rather than on the basis of how much was spent to care for the patient. The final rules also make changes to beneficiary co-payment provisions.

In addition, in June 2000 the HCFA finalized a Medicare PPS for home health care agencies as mandated by the BBA, as amended, to replace the retrospective reasonable-cost-based system. Under the new PPS for home health care agencies, Medicare will pay home health agencies for sixty-day episodes of care. For each episode of care, the home health care agency will receive the national payment rate, adjusted for area wage differences. Outlier payments will be made for beneficiaries whose resource needs are unusually large. Cost reports will continue to be used to settle some reimbursement issues and will impact future rates. The final rules were published in the July 3, 2000, *Federal Register* and take effect on October 1, 2000. See the related discussion "Implementing New Prospective Payment Systems" in the "Audit Issues and Developments" section of the Audit Risk Alert.

Corporate Compliance

Government enforcement activities such as those discussed in previous sections have brought corporate compliance to the planning forefront for many health care organizations. Implementation of a corporate compliance program can assist a health care organization in avoiding unlawful activities, detecting such activities before significant potential damages are incurred, and establishing that any unlawful activities in which it was engaged were inadvertent. A written corporate compliance program should consist of procedures and controls to prevent, detect, and correct wrongdoing within an organization based on the standards included in the Federal Sentencing Guidelines.

Compliance plans are voluntary for health care organizations, unless imposed by the OIG under a corporate integrity agreement (CIA).[4]

SOP 99-1, *Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program*, provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the AICPA Statements on Standards for Attestation Engagements (SSAEs) to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a CIA.

The OIG has issued compliance program guidance for clinical laboratories; hospitals; home health agencies; third-party medical billing companies; hospices; the durable medical equipment,

4. The OIG issued guidance, including an annual report checklist and answers to frequently asked questions about corporate integrity agreements, to assist health care providers operating under corporate integrity agreements (CIAs). The CIA annual report checklist and answers to frequently asked questions are available on the OIG Web site at www.hhs.gov/oig/new.html.

prosthetics, orthotics, and supply industry; Medicare+Choice organizations; nursing facilities; and individual and small group physician practices. These publications are intended to help health care organizations develop effective controls that promote adherence to applicable federal and state laws and program requirements of federal, state, and private health plans. The components of the compliance guidelines are—

1. Written compliance policies and procedures.
2. Designated compliance officer and compliance committee.
3. Training and education for affected employees.
4. Anonymous lines of communication for complaints.
5. Enforcement standards through disciplinary guidelines.
6. Auditing and monitoring.
7. Procedures for responding to reported offenses and developing corrective action initiatives.

Appendix B of this Audit Risk Alert provides a detailed discussion of each of these program components. Also, the OIG's Web site, www.dhhs.gov/progorg/oig, contains the full text of all its compliance program guidance as well as its semiannual reports and work plans.

Executive Summary—Corporate Compliance

- The OIG has issued compliance program guidance for clinical laboratories; hospitals; home health agencies; third-party billing companies; hospices; the durable medical equipment, prosthetics, orthotics, and supply industry; Medicare+Choice plans; nursing facilities; and individual and small group physician practices.
- SOP 99-1, *Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program*, provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the AICPA SSAEs to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a CIA.

What are some of the recent National Association of Insurance Commissioners developments affecting managed care organizations?

Model Audit Rule for HMOs

The National Association of Insurance Commissioners (NAIC) amended the Annual Statement Instructions for 1999 HMO filings to include the Model Audit Rule in the Annual Statement Instructions. Guidance pertaining to the 2000 Annual Statement Instructions is scheduled for issuance in December 2000. Among other matters, the Model Audit Rule requires that:

- All insurers have an annual audit by a CPA, notify the state insurance commissioner if the auditors resign or are dismissed, and provide a letter to the state insurance commissioner regarding disagreements with the former accountants.
- The audit engagement partner may not continue in that capacity in an insurance engagement for more than seven consecutive years, unless this requirement is waived by the state insurance commissioner.
- The audit firm provides the insurer and state insurance commissioner with certain written communications—CPA Qualifications Letter and Notice of Adverse Financial Condition and Significant Deficiencies in Internal Control Letter.

A number of state departments of insurance have either adopted the NAIC Annual Statement Instructions for HMOs or included some or all of its communications requirements in their annual filing checklists. Because many state departments of insurance have explicitly adopted the NAIC Annual Instructions as part of their state reporting package for HMOs, this may result in changes for HMOs and auditors alike. For example, in certain situations an audit of the financial statements will be required, where previously it was not. CPA firms may need to provide specific reports or correspondence to the health plan (and in certain circumstances to the state insurance commission) and CPAs auditing health plans must agree to certain engagement terms and conditions.

Codification of Statutory Accounting Principles

The NAIC, having completed its project to codify statutory accounting principles for certain insurance companies, including managed care companies, issued *Accounting Practices and Procedures Manual* that is effective for years beginning on or after January 1, 2001. Eight of the Statements of Statutory Accounting Principles included in the manual have been specifically modified or written to address issues related to managed care.

Certain AICPA literature, including SOPs and Audit Interpretations, contains references to statutory accounting. The NAIC/AICPA Task Force has prepared a working draft of proposed conforming changes to SOPs and an Audit Interpretation to reflect conforming changes necessitated by the issuance of the *Accounting Practices and Procedures Manual*, a result of the completion of the NAIC codification project. The working draft is available on the AICPA Web site at www.aicpa.org/members/div/auditstd/naicchgs.htm.

Additional discussion on the NAIC codification project and recent NAIC developments can be found in the Audit Risk Alert *Insurance Industry Developments—2000/01*.

Internal Revenue Service Developments

What are some of the recent Internal Revenue Service developments that auditors of health care organizations should know about?

Proposed Regulation on Intermediate Sanctions

The U.S. Department of the Treasury released proposed regulations that were published in the August 4, 1998, *Federal Register* relating to the three excise taxes on excess benefit transactions between tax-exempt organizations and disqualified persons. The proposed regulations define an excess benefit transaction as any transaction in which an economic benefit is provided to any disqualified person if the value of the economic benefit provided exceeds the value of the consideration received. An excess benefit also includes certain revenue sharing transactions and can occur through entities controlled by or affiliated with tax-exempt organizations. A disqualified person is defined as any person who, at any time during the five-year period ending on the date of the transaction, was in a position to exercise substantial influence over the affairs of the organization.

Readers should be alert for the issuance of final regulations.

Acquisition Financing Arrangements

During the past year, the Internal Revenue Service (IRS) has undertaken examinations of acquisition financing transactions by several major not-for-profit health care systems. In an acquisition financing arrangement, debt belonging to the separate entities in the acquisition is combined under a new single indenture. If the IRS determines that the new debt should be classified as a refunding, rather than as a new issuance, the debt would be subject to strict guidelines regarding tax exemption, adversely affecting the new indenture's tax-exempt status.

IRS CPE Text

The IRS Exempt Organization Division publishes annually a series of articles of interest to tax-exempt organizations known currently as *Exempt Organizations Continuing Professional Education Technical Instrùction Program* (CPE Text) for its employees.

The material in the CPE Text is designed specifically for training purposes only. Although not to be used or cited as authority for setting or sustaining a technical position, the CPE Text can provide auditors with insight into the IRS's views on current issues that may affect not-for-profit health care organizations. The CPE Text includes chapters on specific issues, as well as a current developments section with a synopsis of the current developments concerning exempt organizations. Additional information on the CPA Text is available on the IRS Web site at www.irs.ustreas.gov/prod/bus_info/eo/cpe.html.

Tax Exempt and Governmental Entities Division

As part of its modernization plan, the IRS has created the Tax Exempt and Government Entities (TE/GE) Division, comprised of three segments to deal separately with exempt organizations, employee plans, and governmental entities. The TE/GE Division's mission is "to provide tax-exempt and governmental entities customers top quality service by helping them understand and comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to all." With the focus on customer service in the TE/GE Division's mission, its tax compliance strategy will mix educational outreach activities with traditional enforcement activities. That is, when the TE/GE Division identifies significant tax compliance issues, it not only will undertake efforts to identify and correct individual instances of noncompliance, it also will educate the tax-exempt community and governmental community about the nature of the requirements and ways to improve individual compliance.

Executive Summary—Internal Revenue Service Developments

- Readers should be alert for the issuance of final regulations relating to the three excise taxes on excess benefit transactions between tax-exempt organizations and disqualified persons.
- The IRS has undertaken examinations of acquisition financing transactions by several major not-for-profit health care systems. An IRS determination that new debt issued in the transaction should be classified as a refunding, rather than as a new issuance, could adversely affect the new debt's tax-exempt status.
- The IRS publishes annually an *Exempt Organizations Continuing Professional Education Technical Instruction Program* (CPE Text). Although not to be used or cited as authority for setting or sustaining a technical position, the CPE Text can provide auditors with insight into the IRS's views on current issues that may affect not-for-profit health care organizations.
- As part of its modernization plan, the IRS has created the TE/GE Division, comprised of three segments to deal separately with exempt organizations, employee plans, and governmental entities.

New Auditing and Attestation Pronouncements

What are the new auditing and attestation pronouncements that auditors of health care organizations should be aware of?

In this section we present brief summaries of auditing pronouncements issued since the publication of last year's Alert. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard. For a full listing and description of all new auditing and attestation standards, see the AICPA general Audit Risk Alert 2000/01. For information on auditing pronouncements issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter and Journal of Accountancy.*

SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*

In March 2000, the Auditing Standards Board (ASB) issued SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*. SOP 00-1 provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition and the sufficiency of evidential matter and reporting on financial statements of health care entities exposed to material uncertainties. SOP 00-1 also discusses matters to consider in testing third-party revenues and related receivables. SOP 00-1 applies to audits of health care organizations falling within the scope of the AICPA Audit and Accounting Guide *Health Care Organizations* and its provisions are effective for audits of periods ending on or after June 30, 2000.

SOP 00-1 extracts guidance from a number of existing SASs:

- SAS No. 31, *Evidential Matter*
- SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)
- SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342)
- SAS No. 79, *Amendment to Statement on Auditing Standards No. 58*, Reports on Audited Financial Statements (AICPA, *Professional Standards*, vol. 1, AU sec. 508)
- SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333)

A summary of the guidance in SOP 00-1 follows.

Auditor's Responsibilities

With respect to auditing third-party revenues, in addition to the usual revenue recognition considerations, the auditor considers whether amounts ultimately realizable are or should be presently known or are uncertain because they are dependent on some other future, prospective actions or confirming events. Management is responsible for preparing the estimates contained in the financial statements and the auditor evaluates the adequacy of the evidence supporting those estimates, reviews the facts supporting management's judgments, and evaluates the judgments made based on conditions existing at the time of the audit. The fact that net revenues recorded at the time services are rendered differ materially from amounts that ultimately are realized does not necessarily mean the audit was not properly planned or carried out. Similarly, the fact that future events may differ materially from management's assumptions or estimates does not necessarily mean that management's estimates were not valid or the auditor did not follow GAAS with respect to auditing estimates.

Management's Responsibilities

Management is responsible for the fair presentation of its financial statements in conformity with generally accepted accounting principles (GAAP). Despite inherent uncertainties, management is responsible for estimating the amounts recorded in the financial statements and making the required disclosures in accordance with GAAP, based on management's analysis of existing conditions. Management is responsible for assuring that revenues are not recognized until their realization is reasonably assured. Management is responsible for preparing and certifying cost reports submitted to federal and state government agencies in support of claims for payment for services rendered to government program beneficiaries.

Evidential Matter

In the current health care environment, conclusive evidence concerning amounts ultimately realizable cannot be expected to exist at the time of the financial statement audit. The fact that information related to the effects of future program audits, administrative reviews, regulatory investigations, or other actions does not exist does not lead to a conclusion that the evidential matter supporting management's assertions is not sufficient to support management's estimates. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is available or can reasonably be expected to be available in the circumstances. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the valuation of revenues and receivables, and their presentation and disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. If relevant evidential matter exists that the auditor needs and is unable to obtain, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. Pursuant to SAS No. 85, the auditor should obtain written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. Paragraph 20 of SOP 00-1 provides examples of some specific representations that the auditor should obtain.

Potential Departures From GAAP-Related Estimates and Uncertainties

In addition to examining the evidence in support of management's estimates, the auditor determines that there has not been a departure from GAAP with respect to the reporting of those estimates in the financial statements.

- *Unreasonable accounting estimates.* In evaluating the reasonableness of management's estimates, the auditor considers the basis for management's assumptions regarding the nature of future adjustments and management's calculations as to the effects of such adjustments.[5] The auditor cannot determine with certainty whether such estimates

5. The lack of such analyses may call into question the reasonableness of recorded amounts.

are right or wrong, because the accuracy of management's assumptions cannot be confirmed until future events occur. If the auditor believes the estimated amount included in the financial statements is unreasonable, he or she should treat the difference between that estimate and the closest reasonable estimate in the range as a likely misstatement and aggregate it with other likely misstatements. The auditor also should consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. The auditor recognizes that approaches and estimates will vary from entity to entity. Normally, the auditor considers the historical experience of the entity as well as the risk of potential future adjustments. In evaluating valuation allowances, the auditor may consider the entity's historical experience and potential future adjustments in the aggregate. Amounts that ultimately will be realized by an entity are dependent on a number of factors, many of which may be unknown at the time the estimate is first made. Further, even if two entities had exactly the same clinical and coding experience, amounts that each might realize could vary materially due to factors outside of their control. As a result, because estimates are a matter of judgment and their ultimate accuracy depends on the outcome of future events, different entities in seemingly similar circumstances may develop materially different estimates. The auditor may conclude that both estimates are reasonable in light of the differing assumptions.

- *Inappropriate accounting principles.* The auditor also determines that estimates are presented in the financial statements in accordance with GAAP. If the auditor believes that the accounting principles have not been applied correctly, causing the financial statements to be materially misstated, the auditor expresses a qualified or adverse opinion. Valuation allowances are recorded so that revenues are not recognized until the revenues are realizable. Valuation allowances are not established based on the provisions of Financial

Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies.*

- *Inadequate disclosure.* If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with GAAP, the auditor should express a qualified or adverse opinion. SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, provides guidance on the information that reporting entities should disclose regarding risks and uncertainties existing as of the date of the financial statements. In the health care environment, it is almost always at least reasonably possible that estimates regarding third-party payments could change in the near term as a result of one or more future confirming events. For most entities with significant third-party revenues, the effect of the change could be material to the financial statements. Where material exposure exists, the uncertainty regarding revenue realization is disclosed in the notes to the financial statements. Because representations from legal counsel are often key audit evidence in evaluating the reasonableness of management's estimates of potential future adjustments, the inability of an attorney to form an opinion on matters about which he or she has been consulted may be indicative of an uncertainty that should be specifically disclosed in the financial statements. Paragraph 37 of SOP 00-1 provides an illustration of a disclosure that may be appropriate for health care organizations regarding the reasonable possibility of material changes in third-party estimates in the near term.

Executive Summary—SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*

- In March 2000, the ASB issued SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables.*
- SOP 00-1 provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition and the sufficiency of evidential matter and reporting on financial statements of health care entities exposed to material uncertainties.

- SOP 00-1 includes discussions of auditor's and management's responsibilities, departures from GAAP-related estimates and uncertainties, unreasonable accounting estimates, inappropriate accounting principles, and inadequate disclosures.
- Pursuant to SAS No. 85, the auditor should obtain written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. Paragraph 20 of SOP 00-1 provides examples of some specific representations that the auditor should obtain.

Auditing Standards

SAS No. 88, *Service Organizations and Reporting on Consistency*

In December 1999, the AICPA ASB issued SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU secs. 324 and 420). Part 1, "Service Organizations," amends SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU secs. 324.03 and 324.06–.10) to—

1. Clarify the applicability of SAS No. 70 by stating that the SAS is applicable if an entity obtains services from another organization that are part of the entity's information system. It also provides guidance on the types of services that would be considered part of an entity's information system.
2. Revise and clarify the factors a user auditor should consider in determining the significance of a service organization's controls to a user organization's controls.
3. Clarify the guidance on determining whether information about a service organization's controls is necessary to plan the audit.
4. Clarify that information about a service organization's controls may be obtained from a variety of sources.
5. Change the title of SAS No. 70 from *Reports on the Processing of Transactions by Service Organizations* to *Service Organizations*.

Part 2, "Reporting on Consistency," amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles") to—

1. Conform the list of changes that constitute a change in the reporting entity (AU sec. 420.07) to the guidance in paragraph 12 of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes.*

2. Clarify that the auditor need not add a consistency explanatory paragraph to the auditor's report when a change in the reporting entity results from a transaction or event.

3. Eliminate the requirement for a consistency explanatory paragraph in the auditor's report if a pooling of interests is not accounted for retroactively in comparative financial statements.

4. Eliminate the requirement to qualify the auditor's report and consider adding a consistency explanatory paragraph to the report if single-year financial statements that report a pooling of interests do not disclose combined information for the prior year.

All of the amendments contained in SAS No. 88 were effective upon issuance.

SAS No. 89, *Audit Adjustments*

In December 1999, the ASB issued SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU secs. 310, 333, and 380), which amends three SASs to establish audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor. It also clarifies management's responsibility for the disposition of financial statement misstatements brought to its attention. SAS No. 89 amends SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310); SAS No. 85, *Management Representations*; and SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), as follows:

1. SAS No. 83 is amended to include, in the understanding with the client, management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor. Specifically, SAS No. 89 adds the following to the list of matters that generally are included in the understanding with the client:

   > Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

2. SAS No. 85 is amended to require that the management representation letter include an acknowledgment by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. It also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter. It also amends the illustrative management representation letter in paragraph 6 of appendix A to SAS No. 85.

3. SAS No. 61 is amended to require the auditor to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, whose effects management believes are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

These amendments are effective for audits of financial statements for periods beginning on or after December 15, 1999. Early adoption is permitted.

SAS No. 90, *Audit Committee Communications*

SAS No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU secs. 380 and 722), issued by the ASB in December 1999, amends SAS No. 61 and SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722). SAS No. 90 was issued in response to recommendation numbers 8 and 10 of the report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which suggest changes to GAAS.

Among other things, the amendment to SAS No. 61 requires an auditor to discuss with the audit committees of SEC clients certain information relating to the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles and underlying estimates in its financial statements. It also encourages a three-way discussion among the auditor, management, and the audit committee. This amendment is effective for audits of financial statements for periods ending on or after December 15, 2000, with earlier application permitted.

The amendment to SAS No. 71 clarifies that the accountant should communicate to the audit committee or be satisfied, through discussions with the audit committee, that matters described in SAS No. 61 have been communicated to the audit committee by management when they have been identified in the conduct of interim financial reporting. This amendment also requires the accountant of an SEC client to attempt to discuss with the audit committee the matters described in SAS No. 61 prior to the filing of the Form 10-Q. This amendment is effective for reviews of interim financial information for interim periods ending on or after March 15, 2000, with earlier application permitted.

SAS No. 91, *Federal GAAP Hierarchy*

In April 2000, the ASB issued SAS No. 91, *Federal GAAP Hierarchy* (AICPA, *Professional Standards*, vol. 1, AU sec. 411). SAS No. 91 amends SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), to establish a hierarchy of accounting principles for federal governmental entities. SAS No. 91 became effective upon issuance.

SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

In September 2000 the ASB issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 391), that will assist auditors with planning and performing auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities. The guidance in SAS No. 92, which supersedes SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), applies to—

- Derivative instruments, as that term is defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*
- Hedging activities in which the entity designates a derivative or a nonderivative financial instrument as a hedge of exposure for which FASB Statement No. 133 permits hedge accounting.
- Debt and equity securities, as those terms are defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*

The matters addressed by SAS No. 92 include—

- *The need for special skills or knowledge.* Auditors may need special skills or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities, such as the ability to identify a derivative that is embedded in a contract or agreement.
- *Consideration of audit risk and materiality.* SAS No. 92 offers examples of factors that affect inherent risk for assertions about derivatives or securities. SAS No. 92 also discusses control risk assessment.

- *Designing substantive procedures based on risk assessment.* Auditors assess inherent and control risk for assertions about derivatives and securities to determine the nature, timing, and extent of the substantive procedures to be performed. Substantive procedures for derivatives and securities should address the five categories of assertions presented in SAS No. 31:

  1. Existence or occurrence
  2. Completeness
  3. Rights and obligations
  4. Valuation
  5. Presentation and disclosure

SAS No. 92 also discusses hedging activities.

SAS No. 92 is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Earlier application is permitted.

An Audit Guide to complement the SAS has been developed by the ASB and is expected to be available in January 2001. The Guide provides practical guidance for implementing the SAS in all types of audit engagements. The objective of the Guide is both to explain SAS No. 92 and to provide practical illustrations through the use of case studies.

The Guide will include an overview of derivatives and securities, and the general accounting considerations for them, as well as case studies that address such topics as the use of interest rate futures contracts to hedge the forecasted issuance of debt, the use of put options to hedge available-for-sale securities, separately accounting for a derivative embedded in a bond, the use of interest rate swaps to hedge existing debt, the use of foreign-currency put options to hedge a forecasted sale denominated in a foreign currency, changing the classification of a security to held-to-maturity, control risk considerations when service organizations provide securities services, inherent and control risk assessment, and designing substantive procedures based on risk assessments. See the "Resource Central" section of this Audit Risk Alert for order information.

SAS No. 93, *Omnibus Statement on Auditing Standards—2000*

Issued by the ASB in October 2000, SAS No. 93, *Omnibus Statement on Auditing Standards—2000* (AICPA, *Professional Standards*, AU secs. 622, 508, and 315)—

1. Withdraws SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622). The guidance in SAS No. 75 will be incorporated in SSAE No. 10, *Attestation Standards: Revision and Recodification*, to consolidate the guidance on agreed-upon procedures engagements in professional standards. The withdrawal of SAS No. 75 is concurrent with the effective date of SSAE No. 10, scheduled to be issued in January 2001. The guidance in SSAE No. 10 on agreed-upon procedures engagements is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001, with earlier application permitted.
2. Amends SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), to include an identification in the auditor's report of the country of origin of the accounting principles used to prepare the financial statements and the auditing standards that the auditor followed in performing the audit. This amendment withdraws Auditing Interpretation No. 13, "Reference to Country of Origin in the Auditor's Standard Report" of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.53–.55. This amendment is effective for reports issued or reissued on or after June 30, 2001. Earlier application is permitted.
3. Amends SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), to clarify the definition of a predecessor auditor. This amendment is effective for audits of financial statements for periods ending on or after June 30, 2001. Earlier application is permitted.

Auditing Interpretations

Seven new Auditing Interpretations were issued since the publication of last year's Audit Risk Alert:

1. Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls," of SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.19–.31).
2. Interpretation No. 13, "Reference to Country of Origin in the Auditor's Standard Report," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.53–.55).[6]
3. Interpretation No. 7, "Management's and Auditor's Responsibilities With Regard to Related Party Disclosures Prefaced by Terminology Such As 'Management Believes That,'" of SAS No. 45, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 9334.22–.23).
4. Interpretation No. 1, "The Meaning of the Term *Misstatement*" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.01–.04)
5. Interpretation No. 2, "Evaluating Differences in Estimates" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.05–.09)
6. Interpretation No. 3, "Quantitative Measures of Materiality in Evaluating Audit Findings" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.10–.14)
7. Interpretation No. 4, "Considering the Qualitative Characteristics of Misstatements" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.15–.17)

6. Withdrawn by SAS No. 93. See the discussion "SAS No. 93, *Omnibus Statement on Auditing Standards—2000*" in this section of this Audit Risk Alert for further information.

Auditing Interpretations are issued by the Audit Issues Task Force (AITF) of the ASB to provide timely guidance on the application of ASB pronouncements. Interpretations are reviewed by the ASB but are not as authoritative as ASB pronouncements. Nevertheless, auditors may have to justify a departure from an Interpretation if the quality of their work is questioned.

New Attestation Standard

SSAE No. 10, *Attestation Standards: Revision and Recodification*

The ASB expects to issue SSAE No. 10, *Attestation Standards: Revision and Recodification*, in January 2001. SSAE No. 10 does the following:

- Changes the title of AT section 101 to *Attest Engagements*
- Changes the definition of an attest engagement into a statement of applicability of the standard, as follows:

  > This statement applies to engagements in which a certified public accountant in the practice of public accounting (hereinafter referred to as a *practitioner*) is engaged to issue or does issue an examination, a review or an agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party.

- Revises the third general standard to focus on the essential elements of criteria: the criteria must be suitable and must be available to users. The subject matter also must be capable of reasonably consistent evaluation against the criteria.
- Enables true direct reporting on subject matter by eliminating the requirement to make reference to the assertion in the practitioner's report.
- Provides expanded guidance on the circumstances in which the use of attest reports should be restricted to specified parties.
- Supersedes SSAE Nos. 1 through 9.

The new standard also revises and renumbers the AT sections as follows:

	New AT section	*Existing AT section*
Attest Engagements	101	100
Agreed-Upon Procedures Engagements	201	600
Financial Forecasts and Projections	301	200
Reporting on Pro Forma Financial Information	401	300
Reporting on an Entity's Internal Control Over Financial Reporting	501	400
Compliance Attestation	601	500
Management's Discussion and Analysis	701	700

The new SSAE also eliminates the requirement in AT section 201, *Agreed-Upon Procedures Engagements*, for the practitioner to obtain a written assertion in an agreed-upon procedures attest engagement. It also incorporates changes needed as a result of the withdrawal of SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement.* That withdrawal is reflected in SAS No. 93, *Omnibus Statement on Auditing Standards—2000.*

SSAE No. 10 is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001. Early application is permitted.

Help Desk—Look for a new AICPA Practice Aid on how to understand and apply the provisions of SSAE No. 10. It is expected to become available during the first quarter of 2001.

Executive Summary—New Auditing and Attestation Pronouncements

- In December 1999, the ASB issued SAS No. 88, *Service Organizations and Reporting on Consistency.*
- In December 1999, the ASB issued SAS No. 89, *Audit Adjustments,* which amends three SASs to establish audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor.
- In December 1999 the ASB issued SAS No. 90, *Audit Committee Communications.* SAS No. 90 revises SAS Nos. 61 and 71.

- In April 2000, the ASB issued SAS No. 91, *Federal GAAP Hierarchy*. SAS No. 91 amends SAS No. 69 to establish a hierarchy of accounting principles for federal governmental entities.
- The ASB issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, that will assist auditors with planning and performing auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities. The guidance in SAS No. 92 supersedes SAS No. 81, *Auditing Investments*.
- The ASB issued SAS No. 93, *Omnibus Statement on Auditing Standards—2000*.
- SSAE No. 10 is expected to be issued in January 2001.
- Seven new Auditing Interpretations have been issued during the past year.

Audit Issues and Developments

Fraud and Abuse in the Health Care Industry

What effect do the allegations of violations of laws and regulations in the health care industry have on this year's audits?

Many health care organizations that are providers of services to patients covered under Medicare or other federal health care programs have potential exposure to fines and penalties as a result of laws and regulations governing the billing and cost-reporting process.

Allegations of violations of laws and government regulations continued in the health care industry in 2000. The allegations concern violations of a wide variety of laws and regulations, such as the Medicare and Medicaid Anti-Kickback Statute and the False Claims Act, among others. Penalties for violating the laws may include denial of otherwise valid Medicare and Medicaid claims, fines, and civil money penalties (for example, treble damages, plus $5,000 to $10,000 per claim) and exclusion from the Medicare and Medicaid programs. Many lawsuits seeking damages under the civil False Claims Act have been initiated by private individuals (sometimes referred to as *qui tam* relators or "whistle-blowers") seeking to recover a part of the financial penalty assessed against the health care organization.

Auditors should consider including language in the audit engagement letter to clarify the auditor's responsibilities with respect to detecting fraud and abuse during a financial statement audit. SAS No. 83, *Establishing an Understanding With the Client*, provides guidance to auditors about establishing an understanding with a client regarding the services to be performed for each engagement. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and limitations of the engagement.

In addition, the auditor should discuss the auditor's responsibilities under GAAS for communications with members of the organization's audit committee or equivalent body. SAS No. 61, *Communication With Audit Committees*, as amended by SAS No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), establishes a requirement for the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process. In communicating the auditor's responsibility under GAAS, SAS No. 61 notes that it is important for the audit committee to understand that an audit conducted in accordance with GAAS is designed to obtain reasonable, rather than absolute, assurance about the financial statements. Also, SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), provides guidance regarding communications with audit committees. SAS No. 54 notes that the auditor should be assured that the audit committee or others with equivalent authority and responsibility are adequately informed with respect to illegal acts that come to the auditor's attention.

SAS No. 54 also prescribes the nature and extent of the consideration that auditors should give to the possibility of illegal acts by a client in an audit of financial statements conducted in accordance with GAAS. SAS No. 54 also provides guidance on the auditor's responsibilities when a possible illegal act is detected. Determining whether a particular act is illegal generally would be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

The auditor's training, experience, and understanding of the client and the industry may provide a basis for recognizing that some acts coming to the auditor's attention may be illegal. Whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence. For example, determining whether admitting a patient or providing a service is medically necessary, whether a resident's participation in an operation was properly supervised, or whether a particular medical procedure or device was properly approved, is not within the auditor's professional competence.

SAS No. 54 notes that even in the absence of evidence concerning illegal acts, auditors should make certain inquiries of management about such matters as the client's policies relative to the prevention of illegal acts, the use of directives issued by the client, and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations. Certain procedures, although not specifically designed to detect illegal acts, may bring possible illegal acts to an auditor's attention. Such procedures include—

- Reading minutes of board of directors meetings.
- Inquiring of the client's management and legal counsel concerning litigation, claims, and assessments.
- Performing substantive tests of details of transactions or balances.

SAS No. 54 states that when the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

Chapter 2 of the AICPA Audit and Accounting Guide *Health Care Organizations* provides additional discussion of the application of SAS No. 54 in audits of financial statements of health care organizations. Also, the Appendix to SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*, discusses considerations related to governmental investigations. See the related discussion "SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*" in the "New Auditing and Attestation Pronouncements" section of the Audit Risk Alert.

Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*, addresses the accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments. The auditor considers management's application of FASB Statement No. 5 in evaluating the adequacy of accrual for or disclosure of the potential effects of illegal acts (that is, fines and penalties) in the financial statements of health care organizations. If investigations of alleged illegal acts are currently in process, or if claims have been threatened or asserted, additional disclosures may be required by FASB Statement No. 5. Auditors also should consider whether, in view of the far-reaching nature of alleged violations of laws and regulations in the health care industry, management has appropriately considered the disclosure requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Representations from legal counsel are often key audit evidence. The inability of an attorney to form an opinion on matters about which he or she has been consulted may be indicative of an uncertainty that should be disclosed in the financial statements in accordance with FASB Statement No. 5 or SOP 94-6. SAS No. 58, *Reports on Audited Financial Statements*, as amended by SAS No. 79, states that if the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with generally accepted accounting principles (GAAP), the auditor should express a qualified or an adverse opinion. Such judgments should be made in the context of the financial statements taken as a whole and in light of the surrounding circumstances. When considering procedures for identifying litigation, claims, and assessments and for the financial accounting and reporting for such matters when performing an audit in accordance with GAAS, auditors should refer to the guidance set forth in SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337). SAS No. 12 provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for satisfying the auditor as to the financial accounting and reporting for such matters when performing an audit in accordance with GAAS.

Executive Summary—Fraud and Abuse in the Health Care Industry

- Allegations of violations of laws and government regulations (such as the Medicare and Medicaid Anti-Kickback Statute and the False Claims Act, among others) continued in the health care industry in 2000.
- Auditors should consider including language in the audit engagement letter to clarify the auditor's responsibilities with respect to detecting fraud and abuse during a financial statement audit. SAS No. 83 provides guidance to auditors about establishing an understanding with a client regarding the services to be performed for each engagement.
- SAS No. 54 prescribes the nature and extent of the consideration that auditors should give to the possibility of illegal acts by a client in an audit of financial statements conducted in accordance with GAAS. SAS No. 54 also provides guidance on the auditor's responsibilities when a possible illegal act is detected.
- FASB Statement No. 5, *Accounting for Contingencies*, addresses the accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments. The auditor considers management's application of FASB Statement No. 5 in evaluating the adequacy of accrual for or disclosure of the potential effects of illegal acts (that is, fines and penalties) in the financial statements of health care organizations.

Implementing New Prospective Payment Systems

What are some of the issues that auditors should consider when auditing health care organizations affected by the new Medicare prospective payment system regulations for outpatient services and home health agencies?

Payments to health care organizations from Medicare for outpatient services and home health agencies will be affected by new PPS regulations that went into effect in 2000. Inpatient rehabilitation services are scheduled for implementation under a PPS in 2001, and the PPS for skilled-nursing facilities is being phased in over a three-year period that began in 1998.

The new PPS rules may have a significant impact on affected health care organizations. Health care organizations may need to implement new computer systems or make significant modifications to existing systems. These changes to computer systems may be taking place at the same time that the organization is addressing other new regulatory requirements, such as HIPAA Administrative Simplification rules. Personnel will require training in the coding of billing records.

Auditors of health care organizations that will be affected by new PPS rules for outpatient services and home health agencies may want to consider whether these changes in payment regulations create any incentive for clients to look for inappropriate methods of maximizing income, creating opportunities for greater incidences of errors in the financial statements. Some health care organizations may choose to eliminate such programs and services in anticipation of possible adverse financial effects of the new PPS rules.

Auditors may need to consider the impact of these new PPS rules when selecting and performing substantive audit procedures to achieve the audit objectives that the auditor has developed, along with the guidance in SAS No. 31. SAS No. 31 states that in obtaining evidential matter in support of financial statement assertions, auditors develop specific audit objectives in the light of those assertions. In developing the audit objectives of a particular engagement, auditors should consider the specific circumstances of the entity, including the nature of its economic activity and the accounting practices unique to its industry. In selecting the particular substantive tests to achieve the audit objectives that the auditor has developed, auditors should consider, among other things, the risk of material misstatement of the financial statements, including the assessed levels of control risk, and the expected effectiveness and efficiency of particular substantive tests.

Auditors of health care organizations that will be affected by new PPS rules for outpatient services and home health agencies may also need to consider the impact of these new rules on the comparability of financial information when performing analytical procedures on the financial statements of health care organizations. Analytical procedures are used to assist auditors in planning the nature, timing, and extent of other auditing procedures; as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions; and as an overall review of the financial information in the final review stage of the audit. Analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. As an example, auditors of health care organizations affected by new PPS rules may consider comparing recorded net revenue for a home health agency to the number of episodes of care times the average payment rate.

SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures in the planning and overall review stages of an audit. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. Particular conditions that can cause variations in these relationships include, for example, specific unusual transactions or events, accounting changes, business changes, random fluctuations, or misstatements.

> **Help Desk**—The AICPA has developed an Auditing Practice Release (APR), *Analytical Procedures* (Product No. 021069kk), to provide guidance on the effective use of analytical procedures. The APR includes a series of questions and answers, plus an illustrative case study. See the "Resource Central" section of this Audit Risk Alert for order information.

See the related discussion "Prospective Payment Systems for Outpatient Services and Home Health Care Agencies" in the "Regulatory Issues and Developments" section of this Audit Risk Alert.

Revision of SOP 98-3

The illustrative auditor's reports on the financial statements included in SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, have been revised for changes required by *Government Auditing Standards: Amendment No. 2, Auditor Communication.* Specifically, in the paragraph that refers to the *Government Auditing Standards* report on the consideration of internal control over financial reporting and tests of compliance with the provisions of laws, regulations, contracts and grants, the following sentence was added:

> That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

> **Help Desk**—The updated illustrative auditor's reports on the financial statements are posted on the AICPA Web site at www.aicpa.org/belt/a133main.htm. The AICPA Audit Risk Alert *State and Local Governmental Developments—2000*, provides an overview of regulatory developments that may affect audits of state and local governments, including a discussion of the two 1999 General Accounting Office (GAO) amendments to government auditing standards and a Single Audit Guidance update. Auditors should be alert for updates related to the regulatory issues discussed in the Audit Risk Alert *State and Local Governmental Developments—2000*, and for other recent regulatory developments that may affect the audits of governmental entities.

2000 AICPA Health Care Organizations Audit and Accounting Guide

What are some of the conforming changes made to the May 2000 edition of the AICPA Audit and Accounting Guide Health Care Organizations*?*

The 2000 edition of the AICPA Audit and Accounting Guide *Health Care Organizations* (Guide), with conforming changes as of May 1, 2000, has been updated to reflect the issuance of recent authoritative pronouncements. Among other matters, the 2000 edition of the Guide includes discussions alerting readers to the issuance of FASB Statement Nos. 136, *Transfers of Assets to* *a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, and 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*; Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*; and SAS Nos. 89 and 90. Also, a brief summary discussion about GASB Statement No. 34 has been added in paragraphs 1.09 through 1.11 that, among other matters, notes that the governmental health care organizations included within the scope of the AICPA Audit and Accounting Guide *Health Care Organizations* are considered special purpose governments engaged in business-type activities for purposes of applying GASB Statement No. 34. The Guide will be modified to conform to the requirements of these authoritative pronouncements in a future edition of the Guide. The Guide has been updated to reflect the guidance in recent authoritative pronouncements, including SAS No. 88; FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*; GASB Technical Bulletin 2000-1, *Disclosures about Year 2000 Issues—a rescission of Technical Bulletins 98-1 and 99-1*; and SOP 00-1. Paragraph 10.18 in the Guide has been revised to add a footnote noting that not-for-profit health care organizations that have early-adopted FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, should also report unrealized gains and losses on derivatives that do not qualify as a fair value hedge under FASB Statement No. 133, except for the effect of changes in interest accruals, separate from the performance indicator. SOP 99-1, SOP 00-1, and a summary discussion of FASB No. 136 have been added as new appendices to the Guide. Also, chapter 2 of the Guide has an updated discussion of the NAIC risk-based capital requirements for managed care organizations and the NAIC codification project of statutory accounting principles for managed care organizations.

Help Desk—Copies of the Guide may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077 or faxing a request to (800) 362-5066.

Impact of New Accounting Pronouncements

Some health care organizations will be implementing new financial accounting standards that can have a significant impact on their accounting procedures and financial statements, such as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*. See the related discussions in the "Accounting Issues and Developments" section of this Audit Risk Alert. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended, provides guidance on the independent auditor's consideration of internal control in planning the audit of financial statements in accordance with GAAS, including a discussion of the entity's risk assessment for financial reporting purposes. Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Risks can arise or change due to circumstances such as, among other circumstances, the adoption of new accounting pronouncements or changing accounting principles. Auditors should obtain a sufficient knowledge of the client's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides how to address those risks, and be alert to the implications on the internal control of the client.

Auditors should also give consideration to the effect of standards that have been issued but are not yet effective, such as GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, and GASB Statement No. 34. AICPA Auditing Interpretation No. 3, "The Impact on an Auditor's Report of a FASB Statement Prior to the Statement's Effective Date", of AU sec. 410 (AICPA, *Professional Standards*, vol. 1, AU sec. 9410.13–.18), discusses the effect on the financial statements and the auditor's report if the future application of an issued standard will require the future restatement of the financial statements because of the retroactive application of the new standard by prior period adjustment. Although the Interpretation is written in terms of FASB standards, it is equally applicable to GASB standards.

The Interpretation states that an auditor should not qualify his or her opinion if an entity does not adopt a FASB standard early. However, for financial statements that are prepared in conformity with GAAP that are acceptable at the financial statement date but that will not be acceptable in the future, auditors should consider whether disclosure of the impending change in principle and the resulting restatement are data that are essential for a fair presentation in conformity with GAAP. If the auditor decides that the matter should be disclosed and it is not, the auditor should express a qualified or adverse opinion on conformity with GAAP, as required by SAS No. 58, *Reports on Audited Financial Statements*.

The Interpretation gives guidance to evaluate whether prospective changes in GAAP, such as those associated with GASB Statement Nos. 33 and 34, are adequately disclosed. The Interpretation says that even if the auditor decides that the disclosure of the forthcoming change and its effects are adequate and, consequently, decides not to qualify the opinion, he or she nevertheless may decide to include an explanatory paragraph in the report if the effects of the change are expected to be unusually material.

PITF Practice Alerts

The Professional Issues Task Force (PITF), established by the SEC Practice Section (SECPS) Executive Committee, formulates guidance based on issues arising in peer reviews, firm inspections, and litigation to facilitate the resolution of emerging audit practice issues. This guidance takes the form of Practice Alerts. These Practice Alerts—which are based on existing audit literature, the professional experience of the members of the PITF, and information provided by SECPS member firms—provide auditors with information that may help them improve the efficiency and effectiveness of their audits. The information contained the Practice Alerts is nonauthoritative. It represents the views of the members of the PITF and does not represent official positions of the AICPA. As of the writing of this Audit Risk Alert, four new Practice Alerts were issued in 2000:

1. Practice Alert No. 00-4, *Quarterly Review Procedures for Public Companies*

2. Practice Alert No. 00-3, *Auditing Construction Contracts*[7]

3. Practice Alert No. 00-2, *Quality of Accounting Principles—Guidance for Discussion with Audit Committees*

4. Practice Alert No. 00-1, *Accounting for Certain Equity Transactions*

   Help Desk—Copies of these Practice Alerts and a listing of recently and previously issued Practice Alerts are available on the AICPA Web site at www.aicpa.org/members/div/secps/lit/practice.htm.

Official Statements Offering Securities for Sale and Municipal Securities Disclosures

Auditors of health care organizations with tax-exempt debt offerings may wish to consider the information in chapter 19, "Association With Financial Statements Included in Official Statements," of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* which includes guidance on the auditor's responsibilities with respect to an official statement offering securities for sale. Paragraph 19.05 states that an auditor is not required to participate in, or undertake, any procedures with respect to an official statement. In the following situations, however, the auditor should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), for guidance on responsibilities concerning information in the official statement other than the financial statements covered by his or her opinion:

- Manually signing the independent auditor's report included in the offering document.
- Providing written consent to the use of the independent auditor's report in the official statement.

7. PITF 00-3, for example, is intended to serve as a reminder of the important concepts, and provide some best practices, for auditing entities using the percentage of completion method of accounting for long-term contracts.

- Reviewing a draft of the official statement at the client's request.
- Assisting in the preparation of the financial information included in an official statement.
- Issuing an agreed-upon procedures or comfort letter on information included in an official statement.

Auditors may also wish to consider the guidance in Audit Interpretation No. 2, "Consenting to be Named as an Expert in an Offering Document in Connection With Securities Offerings Other Than Those Registered Under the Securities Act of 1933," of SAS No. 37, *Filings Under Federal Securities Statutes* (AICPA, *Professional Standards*, vol. 1, AU sec. 9711.12–.15), and Audit Interpretation No. 3, "Consenting to the Use of an Audit Report in an Offering Document in Securities Offerings Other Than One Registered Under the Securities Act of 1933," of SAS No. 37 (AICPA, *Professional Standards*, vol. 1, AU sec. 9711.16–.17), which address consenting to be named as an expert in an offering document in connection with securities offerings other than those registered under the Securities Act of 1933 and consenting to the use of an audit report in an offering document in securities offerings other than one registered under the Securities Act of 1933.

The discussion "Municipal Securities Disclosure" in the "Accounting Issues and Developments" section of this Audit Risk Alert includes recent SEC developments in the municipal securities sector, including secondary market disclosure. Currently, there is no specific guidance available in the AICPA professional literature regarding the auditor's responsibility with respect to secondary market disclosure filings.

Executive Summary—Audit Issues and Developments

- Payments to health care organizations from Medicare for outpatient services and home health agencies will be affected by new PPS regulations that went into effect in 2000. The new PPS rules may have a significant impact on affected health care organizations. Auditors may need to consider the impact of these new PPS rules when selecting and performing substantive audit procedures to achieve the audit objectives that the auditor has developed, and when performing analytical procedures on the financial statements of health care organizations.

- The illustrative auditor's reports on the financial statements included in SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, have been revised for changes required by *Government Auditing Standards: Amendment No. 2, Auditor Communication.*
- The 2000 edition of the AICPA Audit and Accounting Guide *Health Care Organizations*, with conforming changes as of May 1, 2000, has been updated to reflect the issuance of recent authoritative pronouncements.
- Some health care organizations will be implementing new financial accounting standards that can have a significant impact on their accounting procedures and financial statements.
- Auditors should give consideration to the effect of standards that have been issued but are not yet effective. AICPA Audit Interpretation No. 3 discusses the effect on the financial statements and the auditor's report if the future application of an issued standard will require the future restatement of the financial statements because of the retroactive application of the new standard by prior period adjustment.
- Four PITF Practice Alerts were issued in 2000.
- Chapter 19, "Association With Financial Statements Included in Official Statements," of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* includes guidance on the auditor's responsibilities with respect to an official statement offering securities for sale.

Accounting Issues and Developments[8]

Transfers of Assets

What are the requirements of FASB Statement No. 136, Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*?*

FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, establishes standards for transactions in which an entity—

8. The summaries provided in this section of the Audit Risk Alert are for informational purposes only. Readers should refer to the full text of the accounting pronouncements and SEC releases that are discussed in this section of the Audit Risk Alert. Auditors should be alert for any additional recent developments related to the activities of the standard-setting bodies.

the donor—makes a contribution by transferring assets to a not-for-profit organization or charitable trust—the recipient organization—that accepts the assets from the donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to another entity—the beneficiary—that is specified by the donor. It also establishes standards for transactions that take place in a similar manner but are not contributions because the transfers are revocable, repayable, or reciprocal.

FASB Statement No. 136 requires a recipient organization that accepts cash or other financial assets from a donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to a specified unaffiliated beneficiary to recognize the fair value of those assets as a liability to the specified beneficiary concurrent with recognition of the assets received from the donor. However, if the donor explicitly grants the recipient organization variance power or if the recipient organization and the specified beneficiary are financially interrelated organizations, the recipient organization is required to recognize the fair value of any assets it receives as a contribution received. Not-for-profit organizations are financially interrelated if (a) one organization has the ability to influence the operating and financial decisions of the other and (b) one organization has an ongoing economic interest in the net assets of the other.

FASB Statement No. 136 does not establish standards for a trustee's reporting of assets held on behalf of specified beneficiaries, but it does establish standards for a beneficiary's reporting of its rights to assets held in a charitable trust.

FASB Statement No. 136 requires that a specified beneficiary recognize its rights to the assets held by a recipient organization as an asset unless the donor has explicitly granted the recipient organization variance power. Those rights are either an interest in the net assets of the recipient organization, a beneficial interest, or a receivable. If the beneficiary and the recipient organization are financially interrelated organizations, the beneficiary is required to recognize its interest in the net assets of the recipient organization and adjust that interest for its share of the change in net assets of the recipient organization. If the beneficiary has an unconditional right to receive all or a portion of the specified cash flows from a charitable trust or other identifiable pool of assets, the beneficiary is required to recognize that beneficial interest, measuring and subsequently remeasuring it at fair value, using a valuation technique such as the present value of the estimated expected future cash flows. If the recipient organization is explicitly granted variance power, the specified beneficiary does not recognize its potential for future distributions from the assets held by the recipient organization. In all other cases, a beneficiary recognizes its rights as a receivable.

FASB Statement No. 136 describes four circumstances in which a transfer of assets to a recipient organization is accounted for as a liability by the recipient organization and as an asset by the resource provider because the transfer is revocable or reciprocal. Those four circumstances are if (a) the transfer is subject to the resource provider's unilateral right to redirect the use of the assets to another beneficiary, (b) the transfer is accompanied by the resource provider's conditional promise to give or is otherwise revocable or repayable, (c) the resource provider controls the recipient organization and specifies an unaffiliated beneficiary, or (d) the resource provider specifies itself or its affiliate as the beneficiary and the transfer is not an equity transaction. If the transfer is an equity transaction and the resource provider specifies itself as beneficiary, it records an interest in the net assets of the recipient organization (or an increase in a previously recognized interest). If the resource provider specifies an affiliate as beneficiary, the resource provider records an equity transaction as a separate line item in its statement of activities, and the affiliate named as beneficiary records an interest in the net assets of the recipient organization. The recipient organization records an equity transaction as a separate line item in its statement of activities.

FASB Statement No. 136 requires certain disclosures if a not-for-profit organization transfers assets to a recipient organization and specifies itself or its affiliate as the beneficiary or if it includes in its financial statements a ratio of fundraising expenses to amounts raised.

FASB Statement No. 136 incorporates without reconsideration the guidance in FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power*, and supersedes that Interpretation.

FASB Statement No. 136 is effective for financial statements issued for fiscal periods beginning after December 15, 1999, except for the provisions incorporated from Interpretation No. 42, which continue to be effective for fiscal years ending after September 15, 1996. Earlier application is encouraged. FASB Statement No. 136 may be applied either by restating the financial statements of all years presented or by recognizing the cumulative effect of the change in accounting principle in the year of the change.

Additionally, the discussion of financially interrelated organizations in paragraph 14 of FASB Statement No. 136 states that if a recipient organization and a specified beneficiary are financially interrelated organizations and the recipient organization is not a trustee, the recipient organization shall recognize a contribution received when it receives assets (financial or nonfinancial) from the donor that are specified for the beneficiary. For example, a foundation that exists to raise, hold, and invest assets for the specified beneficiary or for a group of affiliates of which the specified beneficiary is a member generally is financially interrelated with the organization or organizations it supports and recognizes contribution revenue when it receives assets from the donor.

Appendix A to FASB Statement No. 136 provides a diagram to assist entities in the application of FASB Statement No. 136, depicting the process for determining the appropriate accounting. The diagram is a visual supplement to the written standards section of FASB Statement No. 136 and should not be interpreted to alter any requirements of this Statement, nor be considered a substitute for any of those requirements. The relevant paragraphs of the standards section of this Statement and FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, are identified in parenthetical notes in the diagram.

Appendix A also includes ten examples that illustrate the application of this standard in specific situations. (The examples do not address all possible situations.) In "Example 6—Cash Gift to a Healthcare Foundation That Supports Three Affiliated Organizations" (paragraphs 41 through 45 of FASB Statement No. 136), a corporation transfers cash to Healthcare Foundation and requests that Healthcare Foundation use the gift to provide health care benefits to the community. Healthcare Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the benefit of Hospital, Nursing Home, and Walk-in Clinic, all of which are located in the community. Hospital, Nursing Home, Walk-in Clinic, and Healthcare Foundation are affiliates that are controlled by Healthcare System.

Paragraph 42 in Example 6 states that Healthcare Foundation would recognize cash and contribution revenue that increases unrestricted net assets because Corporation did not specify a beneficiary for its gift. Healthcare Foundation can choose how to distribute the gift among the three affiliates.

Paragraph 43 in Example 6 states that periodically, in conjunction with preparing their financial statements, Hospital, Nursing Home, and Walk-in Clinic recognize the changes in their interests in the net assets of Healthcare Foundation. When measuring its interest in Healthcare Foundation, each affiliate would include only the net assets of Healthcare Foundation that are restricted to that affiliate's use. None of them would include in their individual interest the net assets resulting from the gift received from Corporation because Healthcare Foundation can choose how to distribute the gift among the three affiliates. Healthcare System would include the net assets resulting from the gift received from Corporation, as well as other changes in the net assets of Healthcare Foundation, in its interest in the net assets of the foundation.[9]

Paragraph 44 in Example 6 states that if Healthcare Foundation, Hospital, Nursing Home, and Walk-in Clinic entered into an

9. An interest in the net assets of an affiliate would be eliminated if that affiliate were included in the consolidated financial statements of the interest holder.

agreement that specified how unrestricted gifts to Healthcare Foundation should be divided, each affiliate would also include its share of Healthcare Foundation's unrestricted net assets, computed in accordance with that agreement, when it measured its interest in Healthcare Foundation. Similarly, if Healthcare System directed that unrestricted gifts to Healthcare Foundation be distributed to the three affiliates in accordance with a specified formula, each affiliate would include its share of unrestricted net assets computed in accordance with that formula, when it measured its interest in Healthcare Foundation.

Paragraph 45 in Example 6 states that if Corporation had specified that its gift be used for the benefit of Walk-in Clinic rather than giving without restriction, Healthcare Foundation would recognize contribution revenue that increases temporarily restricted net assets because Hospital, Nursing Home, Walk-in Clinic, and Healthcare Foundation are financially interrelated organizations. Their relationship meets both requirements of paragraph 13 of FASB Statement No. 136. Hospital, Nursing Home, and Walk-in Clinic can influence the financial and operating decisions of Healthcare Foundation because all four organizations are under common control and the bylaws of Healthcare Foundation limit its activities to support of its three affiliates. Hospital, Nursing Home, and Walk-in Clinic each have an ongoing economic interest in the net assets of Healthcare Foundation because their rights to the assets held by Healthcare Foundation are residual rights in an ongoing relationship. Walk-in Clinic would include the net assets resulting from the gift received from Corporation in its interest in the net assets of Healthcare Foundation.

Executive Summary—Transfers of Assets

- FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, became effective for financial statements issued for fiscal periods beginning after December 15, 1999. The provisions incorporated from Interpretation No. 42 continue to be effective for fiscal years ending after September 15, 1996.

- FASB Statement No. 136 requires a recipient organization that accepts cash or other financial assets from a donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to a specified unaffiliated beneficiary to recognize the fair value of those assets as a liability to the specified beneficiary concurrent with recognition of the assets received from the donor. FASB Statement No. 136 provides additional guidance for financially interrelated organizations.
- FASB Statement No. 136 requires that a specified beneficiary recognize its rights to the assets held by a recipient organization as an asset unless the donor has explicitly granted the recipient organization variance power.
- FASB Statement No. 136 describes four circumstances in which a transfer of assets to a recipient organization is accounted for as a liability by the recipient organization and as an asset by the resource provider because the transfer is revocable or reciprocal.
- Appendix A to FASB Statement No. 136 provides a diagram to assist entities in the application of this Statement. Appendix A also includes ten examples that illustrate the application of this standard in specific situations.

Derivatives and Hedging Activities

What are some of the recent developments affecting the accounting for derivatives and hedging activities?

FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as—

a. A hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment.

b. A hedge of the exposure to variable cash flows of a forecasted transaction.

c. A hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. FASB Statement No. 133 also contains extensive disclosure requirements.

FASB Statement No. 133 was amended as a result of the issuance of FASB Statement Nos. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*; and 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*. Among other matters, FASB Statement No. 137, which became effective upon issuance in June 1999, defers the effective date of FASB Statement No. 133 to all fiscal quarters of fiscal years beginning after June 15, 2000. Among other matters, FASB Statement No. 138 amends the accounting and reporting standards of FASB Statement No. 133 as follows:

a. The normal purchases and normal sales exception is expanded.

b. The specific risks that can be identified as the hedged risk are redefined so that in a hedge of interest rate risk, the risk of changes in the benchmark interest rate would be the hedged risk.

c. Recognized foreign-currency-denominated assets and liabilities for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 15 of FASB Statement No. 52, *Foreign Currency Translation*, may be the hedged item in fair value hedges or cash flow hedges.

d. Certain intercompany derivatives may be designated as the hedging instruments in cash flow hedges of foreign currency risk in the consolidated financial statements if those intercompany derivatives are offset by unrelated third-party contracts on a net basis.

FASB Statement No. 138 also amends FASB Statement No. 133 for decisions made by the FASB relating to the Derivatives Implementation Group (DIG) process. Certain decisions arising from the DIG process that required specific amendments to FASB Statement No. 133 are incorporated in FASB Statement No. 138.

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

What are the requirements of the new FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*?*

In September 2000, the FASB issued Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* FASB Statement No. 140 replaces FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* It revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but it carries over most of FASB Statement No. 125's provisions without consideration.

Among other matters, FASB Statement No. 140 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. FASB Statement No. 140 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings. FASB Statement No. 140 also requires that a liability be derecognized if and only if either (a) the debtor pays the creditor and is relieved of its obligation for the liability or (b) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

In addition to replacing FASB Statement No. 125, FASB Statement No. 140 rescinds FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, and carries forward the actions taken by FASB Statement No. 125.

FASB Statement No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. FASB Statement No. 140 is effective for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. Disclosures about securitization and collateral accepted need not be reported for periods ending on or before December 15, 2000, for which financial statements are presented for comparative purposes. FASB Statement No. 140 is to be applied prospectively with certain exceptions. Other than those exceptions, earlier or retroactive application of its accounting provisions is not permitted.

EITF Topic D-89, *Accounting for Costs of Future Medicare Compliance Audits*

A number of health care providers have entered into settlement agreements with the U.S. government regarding allegations of Medicare fraud. In addition to the promise to pay specified penalties to the U.S. government, the settlement agreements impose an obligation on the health care provider to engage an independent review organization to test and report on compliance with Medicare requirements each year for the following five years. The FASB staff has been asked whether the commitment to incur the costs of future Medicare compliance audits may be accrued as a liability (equal to the present value of the estimated costs of the audits) when the settlement is agreed to.

Emerging Issues Task Force (EITF) Topic D-89, *Accounting for Costs of Future Medicare Compliance Audits*, states that the FASB staff believes that the settlement agreement represents a promise by a health care provider to perform future compliance audits and a duty or responsibility on which others are justified in relying is created by that promise. However, that promise creates a present duty or responsibility only if an obligating event has already occurred that leaves the health care provider with little or no discretion to avoid the future transfer or use of assets. The obligating event for the costs of the future compliance audits is not entering into the agreement. Therefore, the provider should not recognize a liability for the future Medicare compliance audits on the date the settlement is agreed to.

Other New FASB Pronouncements

- FASB Statement No. 139, *Rescission of FASB Statement No. 53 and Amendments to FASB Statements No. 63, 89, and 121.* A summary is included in the AICPA general *Audit Risk Alert—2000/01.*
- FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, an interpretation of APB Opinion No. 25. A summary is included in the AICPA general *Audit Risk Alert—2000/01.*
- The status of issues considered recently by the EITF of the FASB, which can be found in the AICPA general *Audit Risk Alert—2000/01* (EITF issues discussed through the September 2000 meeting).[10] See the discussion titled "EITF Topic D-89, *Accounting for Costs of Future Medicare Compliance Audits*," in this section in this Audit Risk Alert.

Also, in February 2000, the FASB issued FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements.* Unlike a Statement of Financial Accounting Standards, FASB Concepts Statements do not establish GAAP. The purpose of the series of FASB Concepts Statements is to set forth fundamentals on which financial accounting and reporting standards will be based, and more specifically, to establish the objectives and concepts that the FASB will use in developing standards of financial accounting and reporting.

10. Among the EITF consensuses reached through the September 2000 meeting that may have relevance for certain health care organizations includes EITF Issue 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent.*

SEC Issues and Developments[11]

What are some of the recent SEC developments that may affect health care organizations subject to SEC regulations?

Credibility of Financial Reporting

In September 1998, SEC Chairman Arthur Levitt made a speech outlining serious concerns about the credibility of corporate financial reporting. In his speech, SEC Chairman Levitt expressed concern that a climate has been fostered in which "earnings management," where the results of operations reflect the desires of management rather than the underlying financial performance of the company, is on the rise.

As a result of these concerns, SEC Chairman Levitt announced an "action plan" for restoring the creditability and transparency of financial statements. This action plan, which is discussed in additional detail in the AICPA Audit Risk Alert *Health Care Industry Developments—1999/2000*, includes a request to the AICPA, FASB, SEC, and other accounting and auditing standard-setters to issue additional guidance in such areas as revenue recognition, purchased research and development, restructurings, acquisition write-offs, definition of a liability, and materiality assessment.

Among the SEC developments that have taken place during the past year to address this request were the release of two SABs[12] addressing revenue recognition, restructuring, and asset impairment.

In November 1999, the SEC staff released SAB No. 100, *Restructuring and Impairment Charges*, which provides guidance on the

11. Auditors should be alert for updates to the topics discussed in this section of the Audit Risk Alert and other recent SEC developments. Appendix A to this Audit Risk Alert provides a list of Internet resources, including the SEC Web site that can provide information on issues that may affect health care organizations. Also, see the newly introduced AICPA Audit Risk Alert—*SEC Alert*. The *SEC Alert* provides valuable insights into SEC staff perspectives on important accounting and auditing matters, along with updates on recent SEC activities.

12. SABs are not rules or interpretations of the SEC. SABs represent interpretations and practices followed by staff of the Office of the Chief Accountant and the Division of Corporation Finance in administering the disclosure requirements of the federal securities laws.

accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations, and the recognition and disclosure of asset impairment charges. Many health care organizations are dealing with restructuring and impairment charges due to changes brought about by the implementation of the BBA and other regulatory developments.

Among other matters, SAB No. 100 reiterates existing criteria in EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*; EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*; and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and provides guidance on how the SEC staff interprets and applies the criteria in EITF Issue Nos. 94-3 and 95-3 and FASB Statement No. 121. Costs or charges falling within the scope of EITF Issue Nos. 94-3 and 95-3 or FASB Statement No. 121 should be accounted for in accordance with the appropriate standard. EITF Issue Nos. 94-3 and 95-3 and FASB Statement No. 121 should not be applied to events or circumstances falling outside of their respective scopes. SAB No. 100 states that depreciable lives, amortization periods, and salvage values of long-lived assets need to be reviewed and where appropriate, changed on a timely basis.

SAB No. 100 also provides the SEC staff's views regarding:

- Assessing and measuring enterprise level goodwill for impairment in accordance with APB Opinion No. 17, *Intangible Assets*.
- The measurement of liabilities and other loss accruals assumed in a purchase combination.

In December 1999, the SEC staff released SAB No. 101, *Revenue Recognition in Financial Statements*, which provides guidance on the recognition, presentation, and disclosure of revenue in financial statements filed with the SEC. SAB No. 101 does not change existing accounting guidance on revenue recognition. Rather, SAB No. 101 draws upon the existing rules and explains how the SEC staff applies those rules, by analogy, to other transactions that the existing rules do not specifically address and spells out the basic criteria that must be met before registrants can record revenue. The implementation date of SAB No. 101 was delayed by SAB 101A, *Amendment: Revenue Recognition in Financial Statements*, and again by SAB No. 101B, *Second Amendment: Revenue Recognition in Financial Statements*. SAB 101B delays the implementation date of SAB 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999.

> **Help Desk**—The full text of SAB No. 100 is available at the SEC Web site at www.sec.gov/rules/acctreps/sab100.htm. The full text of SAB No. 101 is available at the SEC Web site at www.sec.gov/rules/acctreps/sab101.htm.

Since the issuance of SAB No. 101, the SEC staff has received inquiries from auditors, preparers, and analysts about how the guidance in accounting standards and SAB No. 101 would apply to particular transactions, and in response to those inquiries, has prepared *Staff Accounting Bulletin No. 101: Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers.*

> **Help Desk**—*Staff Accounting Bulletin No. 101: Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers* is available at the SEC Web site at www.sec.gov.

Additionally, the action plan called for a strengthening of the audit committee's role of "watchdog" over corporate financial reporting. In response to this recommendation, in December 1999, the SEC adopted new rules and amendments to existing rules to improve the disclosure related to the functioning of corporate audit committees and to enhance the reliability and credibility of public company financial statements. The new rules and amendments are largely based on recommendations made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. See the related discussion "SAS No. 90, *Audit Committee Communications*," in the "New Auditing and Attestation Pronouncements" section of this Audit Risk Alert.

Municipal Securities Disclosure

Issuers of municipal bonds, including not-for-profit health care organizations that are conduit issuers of municipal bonds, are exempt from the registration and reporting requirements of the federal securities laws. However, they are not exempt from the antifraud provisions of the federal securities laws, which forbid making misleading statements in or omitting material facts from disclosures made in official statements and annual financial filings and other statements speaking to the market. The antifraud provisions of the federal securities laws state in essence that no entity can make any untrue statement of a material fact or omit to state a material fact necessary to make something said not misleading, in connection with the initial offering or subsequent trading of a security. The focus of the law is on the information given to investors to make an investment decision.

The antifraud provisions apply to a municipal issuer whenever it releases information to the public that is reasonably expected to reach investors and the trading markets. If a statement is made reaching markets or investors, the antifraud provisions apply regardless of whether the statement is on paper or delivered electronically. The SEC Interpretive Release *Use of Electronic Media* provides interpretive guidance to corporate and municipal issuers on how securities fraud laws apply to such matters as the electronic delivery of documents and electronic disclosures.

The principal sources of SEC guidance on the operation of the municipal disclosure framework and application of the antifraud provisions are:

1. *SEC releases.* In March 1994, the SEC issued the Interpretive Release *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*, which reviews numerous municipal disclosure practices needing improvement in light of the antifraud provisions. In November 1994, the SEC issued *Secondary Market Disclosure*, an amendment to Rule 15c2-12. This Release requires that in addition to requiring municipal securities dealers to obtain a contractual commitment from issuers to receive and distribute an official statement when bonds are

initially issued, municipal securities dealers must also contract with issuers for them to continue to provide continuing disclosures at certain times thereafter for the life of the bond issue. Continuing disclosure, or secondary market disclosure requirements, are made by issuers providing to nationally recognized municipal securities information repositories (NRMSIRs) and state information depositories (SIDs) (a) annual continuing disclosure documents and (b) material events notices. Annual continuing disclosure documents are financial information, including audited financial statements that are provided annually. Material events notices are required for eleven specific events with respect to municipal securities, such as principal and interest payment delinquencies and nonpayment-related defaults. Material event notices are provided through a press release or other written notification on an "as-needed" basis and do not involve financial statements.

2. *SEC enforcement actions in the municipal sector involving the antifraud provisions.* The SEC has prepared *Municipal Securities Cases and Materials*, a compilation of the over 140 enforcement proceedings that the SEC has brought over the last thirty years, including actions against issuers, issuer officials, accountants, underwriters, financial advisers, consultants, and bond counsels involved in municipal securities proceedings. Several proceedings involve health care organizations. The compilation is available on the SEC Web site at www.sec.gov/offices/munisec/mbonds/omstoc.htm.

In May 2000, the SEC brought an enforcement action against a not-for-profit health care system, the first municipal fraud case based solely on secondary market disclosures. This enforcement action also represented the first time the SEC enforced Rule 102(e), which allows it to bar accountants from practicing before the SEC in the municipal market. SEC representatives have described this enforcement action as "a heads-up to the nonprofit health care sector" and a "wake up call to conduit health care borrowers and their officers regarding their disclosure responsibilities under federal securities laws in both primary and secondary markets." The SEC has taken other enforcement actions in recent years for failure to disclose deteriorating financial conditions in bond disclosures. Additional information on SEC enforcement actions is available on the SEC Web site at www.sec.gov.

Formal Documentation Requirements of FASB Statement No. 133

The SEC staff has observed compliance issues with the formal documentation requirements of FASB Statement No. 133 among early adopters of this Statement.

Contemporaneous formal documentation. The SEC staff noted that one of the fundamental requirements of FASB Statement No. 133 is that formal documentation be prepared contemporaneously with designation of a hedging relationship. In addition, on initial adoption, all hedging relationships must be redesignated anew and documented pursuant to the Statement's requirements. The SEC staff has challenged the appropriateness of hedge accounting in instances where contemporaneous documentation was not prepared.

Specific designation of the hedged forecasted transaction in cash flow hedges. The SEC staff noted that FASB Statement No. 133 stresses that formal documentation must identify the hedged forecasted transaction with sufficient specificity so that when a transaction occurs, it is clear whether that particular transaction is the hedged transaction. Documentation should include reference to timing, nature, and amount of the forecasted transaction. The SEC staff has found instances where this documentation was insufficient.

Documenting how hedge effectiveness will be assessed. The SEC staff noted that while FASB Statement No. 133 provides flexibility in determining how to assess hedge effectiveness, the methodology used must be reasonable and be documented at the inception of the hedging relationship. The SEC staff has noted instances where documentation was insufficient.

Executive Summary—SEC Issues and Developments

- SEC SAB No. 100, *Restructuring and Impairment Charges*, provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations and the recognition and disclosure of asset impairment charges.
- SAB No. 101, *Revenue Recognition and Financial Statements*, provides guidance on the recognition, presentation, and disclosure of revenue in financial statements filed with the SEC.
- The principal sources of SEC guidance on the operation of the municipal disclosure framework and of the antifraud provisions are SEC releases and SEC enforcement actions in the municipal sector involving the antifraud provisions.
- In May 2000, the SEC brought an enforcement action against a not-for-profit health care system, the first municipal fraud case based solely on secondary market disclosures. This enforcement action also represented the first time the SEC enforced Rule 102(e) in the municipal market.
- The SEC staff has observed compliance issues with the formal documentation requirements of FASB Statement No. 133 among early adopters of this Statement.

National Federation of Municipal Analysts Recommended Best Practices

In August 2000 the National Federation of Municipal Analysts (NFMA) released "Recommended Best Practices in Disclosure for Hospital Debt Transactions." This voluntary disclosure project was undertaken in response to complaints from investors and other parties about the quality and timing of hospital bond secondary market disclosures. A separate voluntary disclosure project is under way to address non-hospital-related health care organization financings, including nursing homes, assisted-living facilities, and continuing-care facilities.

Among other matters, the recommended best practices include guidelines that call for hospitals to disclose on a quarterly basis unaudited financial statements that contain an income statement, cash flow statement, and balance sheet. The recommendations would apply differently to stand alone hospitals, individual hospitals and multi-hospital systems. The recommended best practices are posted on the NFMA Web site at www.nfma.org.

New GASB Standards

The Audit Risk Alert *State and Local Governmental Developments—2000* includes a discussion of recently released GASB accounting pronouncements, including GASB Statement Nos. 33 and 34; GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities—an amendment of GASB Statement No. 34*; and GASB Statement No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*, as well as valuable information on current issues and audit risks facing governmental organizations. Information on recently issued GASB Standards is available on the GASB Web site at www.gasb.org.

As a reminder, GASB Statement No. 20, *Accounting and Financial Reporting by Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, clarifies how FASB Statements affect governmental entities with business-type accounting and financial reporting. In all cases, governmental health care organizations are required to follow GASB pronouncements unless excluded from the scope of a particular pronouncement. GASB Statement No. 20 provides two alternatives for FASB pronouncements. Under the first, governmental health care organizations should apply FASB pronouncements and those of its predecessors, such as the APB, issued through November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. Under the second alternative, organizations may also elect to apply FASB pronouncements issued after that date, again, provided that they do not conflict with or contradict GASB pronouncements. Either alternative must be used consistently and disclosed in the summary of significant accounting policies note to the financial statements.

On the Horizon[13]

FASB Exposure Drafts

What are some of the exposure drafts that have been issued by the FASB for comment?

Proposed Statement of Financial Accounting Standards on Consolidated Financial Statements

In February 1999, the FASB issued an exposure draft of a proposed FASB Statement, *Consolidated Financial Statements: Purpose and Policy,* a revision to an exposure draft issued in October 1995. This proposed Statement would establish standards that specify when entities should be included in consolidated financial statements. It would apply to business enterprises and not-for-profit organizations that control other entities regardless of the legal form of the controlling and controlled entities. The proposed statement would—

1. Define *control* as the ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities. For purposes of consolidated financial statements, control involves decision-making ability that is not shared with others.

2. Require that a controlling entity (parent) consolidate all entities that it controls (subsidiaries) unless control is temporary at the time the entity becomes a subsidiary.

3. Preclude consolidation of a new subsidiary if a parent's control is temporary at the date that control is obtained.

13. This section briefly summarizes some of the exposure drafts that have been released by the FASB and the ASB for comment and which were outstanding at the time of the writing of this Audit Risk Alert. They are nonauthoritative and cannot be used as a basis for changing GAAS or GAAP. Auditors should be alert for the issuance of final standards or other developments related to FASB and ASB projects. Further information related to the FASB projects can be obtained from the FASB Web site at www.fasb.org. Further information related to the ASB projects can be obtained from the AICPA Web site at www.aicpa.org.

The proposed Statement would supersede the provisions of paragraphs 1 through 3 and 5 of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended, and would amend ARB No. 51 to extend its provisions to not-for-profit organizations. The proposed Statement would also supersede or amend other accounting pronouncements.

Proposed Statement of Financial Accounting Standards on Business Combinations and Intangible Assets

In September 1999, the FASB issued an exposure draft of a proposed FASB Statement, *Business Combinations and Intangible Assets*. This proposed Statement is divided into two parts. Part I addresses the method of accounting for business combinations. The FASB clarified the scope of Part I of the proposed Statement so that all organizations that fall outside the definition of "not-for-profit organization" in FASB Statement No. 116 are within the scope of this exposure draft, as is the acquisition of a not-for-profit organization by a business enterprise. Part II would establish new accounting standards for both identifiable and unidentifiable intangible assets acquired (including goodwill) whether acquired singularly, in a group, or as part of a business combination. Part II would apply to both not-for-profit and for-profit organizations.

The proposed Statement would amend APB Opinion No. 16, *Business Combinations*; supersede APB Opinion No. 17, *Intangible Assets*; and would also amend or supersede other accounting pronouncements.

The FASB has decided to address issues specific to combinations of not-for-profit organizations as a separate project and has begun its deliberations on this project. As of the writing of this Audit Risk Alert, the FASB has not issued any exposure drafts related to this project. A project summary, including the project description and background, summary of tentative conclusions, and immediate plans is available on the FASB Web site at www.fasb.org.

Proposed Statement of Financial Accounting Standards on Accounting for Obligations Associated with the Retirement of Long-Lived Assets

In February 2000, the FASB issued an exposure draft of a proposed FASB Statement, *Accounting for Obligations Associated with the Retirement of Long-Lived Assets,* a revision to an exposure draft issued in 1996. This proposed Statement would apply to all entities that incur obligations associated with the retirement of tangible long-lived assets. The proposed statement would require—

1. An asset retirement obligation be recognized as a liability, initially measured at fair value, when incurred.
2. An offsetting amount, referred to as an asset retirement cost, be recognized as an increase in the carrying amount of the associated long-lived asset.
3. Recognition of interest expense on the liability and depreciation expense on the capitalized asset retirement cost after initial recognition and measurement.

Proposed Statement of Financial Accounting Standards on Asset Impairment and Disposals

In July 2000, the FASB issued an exposure draft of a proposed FASB Statement, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities,* which would supersede FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* The proposed Statement would establish a single accounting model for long-lived assets to be disposed of. This accounting model would also apply to certain obligations associated with a disposal activity, including the restructuring of an existing activity, whether or not it involves the disposal of long-lived assets. The proposed Statement would retain the recognition and measurement provisions of FASB Statement No. 121 for long-lived assets to be held and used and would provide additional guidance for implementing those provisions. In addition, the proposed Statement would supersede the accounting and reporting provisions of APB Opinion No. 30, *Reporting* *the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, that address the disposal of a segment of a business and nullify most of the guidance provided by EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*.

ASB Exposure Drafts

What exposure draft has been issued by the ASB for comment?

Proposed Statement on Auditing Standards—*Amendment to Statement on Auditing Standards No. 55,* Consideration of Internal Control in a Financial Statement Audit, *as Amended by SAS No. 78,* Consideration of Internal Control in an Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55

Issued in October 2000, this proposed statement on auditing standards amends SAS No. 55, to provide guidance to auditors about the effect of information technology (IT) on internal control, and on the auditor's understanding of internal control and assessment of control risk. The ASB believes the guidance is needed because entities of all sizes increasingly are using IT in ways that affect their internal control and the auditor's consideration of internal control in a financial statement audit. Consequently, in some circumstances, auditors may need to perform tests of controls to perform effective audits.

Resource Central

What other AICPA publications, services, and products can be of value to auditors of health care organizations?

Order Department (Member Satisfaction)

To order AICPA products, including AICPA products discussed in this Audit Risk Alert, call (888) 777-7077; write AICPA Order

Department, CLA10, P.O. Box 2209, Jersey City, NJ 07303-2209; fax (800) 362-5066. For best results, call Monday through Friday between 8:30 A.M. and 7:30 P.M. EST. Obtaining product information and placing online orders can be done at the AICPA's Web site, www.aicpa.org.

Health Care Organizations Checklists

The AICPA Accounting and Auditing Publications Team has published a revised edition of *Checklists and Illustrative Financial Statements for Health Care Organizations*, a nonauthoritative Practice Aid for preparers or reviewers of financial statements of health care organizations.

National Health Care Industry Conference

The AICPA National Health Care Industry Conference, developed in cooperation with the HFMA, is designed to update auditors and health care financial executives on significant accounting, legal, financial, and tax developments affecting the health care industry. Information on the conference may be obtained by calling the AICPA CPE Conference Hotline at (888) 777-7077 or visiting the AICPA Web site at www.aicpa.org.

Continuing Professional Education Courses

The AICPA offers continuing professional education (CPE) courses related to health care organizations. Among the available titles are the following:

Group Study Courses

- Health Care Consulting: New Practice Opportunities
- Health Care Industry and Medical Practice Valuation
- Managed Care Issues—What the CPA Needs to Know

Self-Study Courses

- Health Care Consulting: New Practice Opportunities (Product No. 731740kk)
- Fraud in the Health Care Industry (Product No. 735207kk)
- Corporate Compliance Plans for Health Care Providers: Minimizing the Risk of Fraud (Product No. 735111kk)
- Managed Care Issues—What the CPA Needs to Know (Product No. 730081kk) [Text] or (Product No. 738140kk) [CD]

The AICPA has launched a new online learning tool, AICPA InfoBytes. An annual fee ($95 for members and $295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments.

> **Help Desk**—For more information about AICPA CPE courses, call the AICPA (Member Satisfaction) at (888) 777-7077 or visit the AICPA Web site at www.aicpa.org. You can register for AICPA InfoBytes at infobytes.aicpaservices.org.

Assurance Services Alerts

The Assurance Services Alert series, *CPA ElderCare Services*, *WebTrust*^{SM}, and *CPA SysTrust*^{SM}, provides practitioners with information about those emerging practice areas. These Assurance Services Alerts provide both an introduction to those who are unfamiliar with assurance services and an update of important new developments for those who have expanded their practice to include these assurance services. The 2000 Assurance Services Alerts are available from the AICPA for the following services:

- *WebTrust*^{SM}*—2000* (Product No. 022249kk)
- *CPA ElderCare Services—2000* (Product No. 022248kk)
- *CPA SysTrust*^{SM}*—2000* (Product No. 022253kk)

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

The AICPA Professional Ethics Team answers inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Technical Practice Aids

AICPA Technical Practice Aids includes questions received by the AICPA Technical Hotline on various subjects and the responses to those questions. Section 6400 of *Technical Practice Aids* includes questions and answers specifically pertaining to health care organizations. *Technical Practice Aids* is available both as a subscription service (Product No. G01013kk) and in paperback form (Product No. 005059kk).

References for Additional Guidance

Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in the AICPA general *Audit Risk Alert—2000/01* (Product No. 022260kk), and AICPA *Compilation and Review Alert—2000/01* (Product No. 022270kk). The new AICPA Audit Risk Alert—*SEC Alert*, (Product No. 022272kk), provides valuable insights into SEC staff perspectives on important accounting and auditing matters, along with updates on recent SEC activities. The new AICPA Audit Risk Alert *The ABC's of Independence* (Product No. 022271kk) is a must-read basic primer on the fundamentals of independence. The AICPA Audit Risk Alert *Insurance Industry Developments 2000/01* (Product No. 022262kk) provides information on current issues and audit risks facing organizations with insurance-type operations.

The AICPA Audit Risk Alert *State and Local Governmental Developments—2000* (Product No. 022251kk) includes a discussion of recently released GASB accounting pronouncements and projects, as well as information on current issues and audit risks facing governmental organizations. Also, the AICPA Audit Risk Alert *Not-for-Profit Organizations Industry Developments—2000* (Product No. 022246kk) provides information on current issues and audit risks facing not-for-profit organizations. The 2001 editions of the Audit Risk Alert *State and Local Governmental Developments* and Audit Risk Alert *Not-for-Profit Organizations Industry Developments* will be available in the second quarter of 2001.

These Alerts may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077 or faxing a request to (800) 362-5066. Obtaining product information and placing online orders can be done at the AICPA's Web site, www.aicpa.org.

Copies of FASB or GASB publications may be obtained directly from the FASB or GASB by calling the Order Department at (800) 748-0659, or writing the FASB or GASB Order Department, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116.

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This Audit Risk Alert replaces *Health Care Industry Developments—1999/2000*. The *Health Care Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would be appreciated. You may e-mail these comments to mkasica@aicpa.org or write to:

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Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

APPENDIX A

The Internet—An Auditor's Research Tool

Some Web sites that may provide information to auditors are listed in the following table:

Name of Site	*Content*	*Internet Address*
American Institute of CPAs (AICPA)	Information for CPAs on accounting, auditing, industry activities, the activities of the AICPA, and other matters	www.aicpa.org
Financial Accounting Standards Board (FASB)	Information on the activities of this standard-setting body	www.fasb.org
General Accounting Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Information on the activities of this standard-setting body	www.gasb.org
Healthcare Financial Management Association (HFMA)	HFMA information	www.hfma.org
Health Care Finance Administration	Administration information and literature	www.hcfa.gov
Independence Standards Board (ISB)	Information on the activities of the ISB	www.cpaindependence.org
IRS Information for Tax-Exempt Organizations	Information and answers to frequently asked questions regarding tax-exempt organizations	www.irs.ustreas.gov/prod/bus_info/eo

(continued)

Name of Site	*Content*	*Internet Address*
National Association of Insurance Commissioners (NAIC)	NAIC information and publications	www.naic.org
National Federation of Municipal Analysts (NFMA)	NFMA information	www.nfma.org
U.S. Department of Health and Human Services (HHS)	HHS information and literature	www.hhs.gov www.dhhs.gov
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
U.S. Office of Management and Budget (OMB)	OMB information and literature	www.whitehouse.gov/OMB/
U.S. Securities and Exchange Commission (SEC)	SEC information and literature and EDGAR database	www.sec.gov

APPENDIX B
Compliance Guidelines

Compliance Policies and Procedures

Compliance plans should require development and distribution of written compliance policies, standards, and practices that identify specific areas of risk and vulnerability for the organization covered under the plan, potentially including those listed in the applicable Office of the Inspector General (OIG) compliance guidance. These policies, standards, and practices should be given to all individuals whom they might affect, including employees, independent contractors, and any other agents. The organization should develop and distribute to all affected employees written standards of conduct (updated regularly) that include a clear commitment to compliance by senior management. These standards should emphasize the prevention of fraud and abuse. Employees should be required to certify that they read and understood the standards of conduct when they are first hired and whenever a new standard is issued. In addition to these general standards, a comprehensive set of policies and procedures reflecting applicable legal requirements should be established. The policies should be coordinated with appropriate training and educational programs and emphasize issues of special concern to the OIG. These issues will differ depending upon the type of health care services being offered and the nature of the organization providing them. A risk analysis identifying and ranking compliance and business risks should serve as the basis for the organization's written policies. OIG compliance program guidance may include specific suggested provisions.

Compliance Officer and Compliance Committee

The organization should designate an individual of high integrity to serve as its compliance officer. He or she may have other responsibilities, and need not be a company employee, that is, the compliance function can be outsourced. However, the individual should be at a high level with access to the organization's governing body, senior management, and legal counsel. The compliance officer should, among other things, oversee and monitor implementation of the compliance program. The OIG also generally recommends establishment of a compliance committee—consisting of individuals with a variety of skills—to advise the compliance officer and assist in the implementation of the compliance program.

Training and Education

On an annual basis, each employee should be required to attend a general session on compliance, addressing federal and state legal authorities, policies of private payers, corporate ethics, and the organization's standards of conduct. Physicians, independent contractors, and other agents of the organization should also attend. Participants should then be required to certify their knowledge and commitment to the organization's standards of conduct; this written certification should be retained by the organization for its employees and made part of its contract with consultants. In addition to specifically identified risk areas, the educational programs should address, where appropriate—

- Government and private payer reimbursement principles.
- General prohibitions on paying or receiving remuneration for referrals.
- Proper confirmation of diagnoses.
- Claims for physician services rendered by nonphysicians (that is, the "incident to" rule and the physician physical-presence requirement).
- Prohibitions against signing a form for a physician without the physician's authorization, altering medical records, or prescribing medications and procedures without proper authorization.
- Proper documentation of services rendered.
- Duty to report misconduct.

Employees should be required to have a minimum number of hours of education each year. Periodic programs addressing compliance issues should be made available to employees, as necessary.

Lines of Communication

Health care organizations should maintain an open line of communication between their employees and the compliance officer. This should permit employees to seek clarification regarding a company policy, practice, or procedure and to report fraud, waste, or abuse, including through use of hotlines, e-mail, written memoranda, and newsletters. Employees should be permitted to report matters anonymously. Written confidentiality and nonretaliation policies should be developed and distributed to encourage reporting. Reports that suggest substantial violations of compliance policies, legal authorities, or private payer requirements should be documented and investigated promptly. The compliance officer should maintain a log of calls, the nature of the investigation, and its results. Information relating to reported incidents should be reported to the organization's governing body, chief executive officer, and compliance committee. Based on the need to examine complex issues on a case-by-case basis, the compliance officer should work closely with legal counsel.

Enforcement Standards

An effective compliance program should include guidelines addressing disciplinary action for corporate officers, managers, employees, physicians, and other health care professionals who fail to comply with the organization's standards of conduct, policies and procedures, federal and state laws, or requirements of private payers, or who have engaged in wrongdoing that could impair the organization's status as an honest provider of health care services. Intentional or reckless noncompliance could result in significant sanctions. Disciplinary actions also may result, based on a reasonable employee's failure to detect a violation resulting from his or her negligence or recklessness. Disciplinary guidelines should be consistently applied to employees on all levels; officers, managers, supervisors, and health care professionals should be held accountable for the foreseeable failure of subordinates to comply with relevant rules and procedures.

Health care organizations should conduct a reasonable background investigation of new employees who will have discretionary authority regarding legal compliance or compliance oversight, including a reference check. Applicants should be required to disclose any prior criminal conviction or exclusion action. Employment of individuals recently convicted of a criminal offense related to health care or listed as debarred, excluded, or otherwise ineligible for participation in a federal health program should be prohibited. Employees should not have direct responsibility for or involvement in federal health care programs while charges are pending against them.

Auditing and Monitoring

A successful compliance program should include an ongoing evaluation process that monitors the plan's implementation and reports to senior management on a regular basis. Many monitoring techniques are available, but regular, periodic compliance audits by internal or external auditors with expertise in federal and state regulatory requirements are an effective way to promote and ensure compliance. These audits should address compliance with applicable legal requirements, particularly those that have been the focus of government attention and areas of specific concern to the particular health care organization. Monitoring techniques may include sampling protocols that permit review of variations from established baselines followed by prompt, corrective action as appropriate, such as refund of overpayments.

A health care organization should evaluate periodically whether elements of its compliance program have been satisfied through on-site visits, personnel interviews and questionnaires, review of records supporting claims for payments, trend analyses to discover deviations, testing billing staff, or other evaluation techniques. Compliance reports should address the need for specific corrective actions and the implementation of corrective actions previously identified as necessary. The health care organization should document efforts to comply with various regulatory requirements, including requests for advice from a government agency and its reasonable reliance on any such advice received.

Responding to Reported Offenses and Developing Corrective Action Initiatives

The OIG emphasizes that "[d]etected but uncorrected misconduct can seriously endanger the mission, reputation, and legal status" of the health care organization. Consequently, upon receipt of any report or reasonable indication of suspected noncompliance, the organization should determine whether a material violation of a law, regulation, or the compliance program has occurred, and if so, correct the problem, including, as appropriate, an immediate referral to law enforcement authorities, a corrective action plan, a report to the government, and return of any overpayments. If there is credible evidence of misconduct which may be unlawful, the health care organization should report the misconduct to the appropriate government authority within sixty days to "demonstrate [its] good faith and willingness to work with governmental authorities to correct and remedy the problem."

APPENDIX C

AICPA Industry Expert Panel

The AICPA will be developing an expert panel that focuses on identifying business reporting issues, with an emphasis on audit and accounting matters, in the health care industry. The Health Care Expert Panel is one of a number of industry-specific panels that have been created as part of the AICPA's effort to revamp the Institute's volunteer structure.

The Expert Panel will identify and discuss industry-specific emerging issues and their effect on CPAs, identify additional guidance, if any (both traditional and nontraditional), that members need to be effective and to protect the public, and develop plans for providing input on initiatives that should be brought to the attention of standard-setters or the AICPA prioritization mechanism, and other matters.

Joining the Expert Panel

Expert Panel members should be forward thinking, vision-aligned, cross-functional individuals. In addition, Panel members may be non-CPA business professionals. *Cross-functional* is intended to include members with expertise in the traditional areas of accounting and auditing, as well as awareness and, perhaps, expertise beyond the traditional areas. For example, depending on the needs of the area covered by the Expert Panel, the members might have expertise in assurance services, operational and management issues, technology, corporate governance, legislation, and other areas, in addition to expertise in the traditional areas of accounting and auditing.

Rewards of Joining the Panel

Serving on the Panel is a rewarding and enriching experience. Panel members interact with other top professionals in their industry, and address and resolve key forces, issues, and trends shaping the health care industry. Moreover, Expert Panel members take the knowledge and experience they gain on the Panel with them, enriching themselves, their work, and their firms.

Panel members will serve one-year terms, generally for three consecutive years.

Apply now. For more information on the Expert Panels or to apply, visit AICPA Volunteer Central at www.skillscape.com/aicpaonline.

www.aicpa.org

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